Globalization and Economic Crisis

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Cosimo Perrotta and Claudia Sunna
(editors)

Introduction

Reconstructing the Debate on Globalization: from *Optimism* to *Doubt*

Claudia Sunna

1. The Raising of the Globalization processes. The Optimistic Era

Starting from the mid-1990s, the globalization process was seen as a positive phenomenon which was leading economies toward a path of sustained growth.

Jeffrey Sachs and Andrew Warner (1995) maintained that the globalization processes, measured by the market based international flows of goods and capitals, besides been responsible for the growth processes in developed countries, had the capacity to promote absolute convergence in income levels between developed and poor countries. In other words, since the poor countries, thanks to globalization processes, grow at higher rates than the developed countries, this in the long term leads to homogeneity in income levels at the international level.

According to Sachs and Warner, since 1970 this process was driven by the "most remarkable institutional harmonization and economic integration among nations in world history" (ibid., p. 1)[1] and

[1] According to the authors this process was not completely new. A first wave of global economic integration was witnessed during the period that ran from 1870s to the first World War. In the period within the two world

put forward by the newly established World Trade Organization and the International Monetary Fund. Economic integration means "not only increased market-based trade and financial flows, but also institutional harmonization with regard to trade policy, legal codes, tax systems, ownership patterns, and other regulatory arrangements" (ibid., p. 2). This process has the formidable capacity to explain the potential of growth of internationally integrated economies and "the onset or avoidance of economic crises" (ibid.). In conclusion the two main "promises" of globalization, which were of vital importance for many poor countries, were the reduction of poverty and the ensuring of economic stability. As we will see in section 2 these promises were systematically unfulfilled.

This optimistic approach towards the globalization processes is emphasized, although not unanimously, by many authors. Jeffrey Frankel maintains that globalization processes have generated a positive impact in the social sphere and in particular on the distribution of income (since the expansion of trade increases aggregate income and ultimately equality) and in protecting the environment (Frankel 2000, p. 64). This latter case, as the distribution of income, would be described with an "environmental Kuznets curve". According to this curve a growing income increases the material chances to protect the environment against pollution caused by industrial production.

As it will be detailed below, in this literature, globalization is intended primarily as a phenomenon derived from economic processes. This means mainly the reduction of transport costs, which originate in the private sector, and trade liberalization, resulting from decisions taken in the public sphere.

The process of integration of the world economies would therefore also have positive effects in reducing poverty and this seems to be the orientation of the World Bank. In 2002 the Bank

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wars this process of integration was interrupted as countries started to erect trade barriers, Sachs, Warner, 1995, pp. 5-12. For a comparison between the two waves of globalization see Bordo, Eichengreen, Irving 1999. For a critical reconstruction of this *vulgate* see Chang 2003, pp. 13-19; Chang 2008, pp. 26-31; Milanovic 2003.

published a report entitled *Globalization, Growth and Poverty: Building an Inclusive World Economy*, edited by Paul Collier and David Dollar.

From the report, albeit with due caution, it appears that in some countries globalization reduces poverty and inequality in income distribution. In this study the definition of the components of the globalization process is further articulated. Among the factors responsible for globalization, in addition to reduced transport costs and trade liberalization, the authors referred also to the spread of new media, namely the Internet, the increase in capital flows and the boost to the international migration of labor (Collier, Dollar 2002, p.11).

The general scheme of the report is that well internationally integrated economies generally grow faster than the other economies. This growth in poor countries is responsible for the escaping from rural poverty, for the increase in labour productivity and, if the process is well driven by national economies and international agencies, for the reduction of the income gap between rich and poor countries.

The observed decrease in global poverty is the result mainly of the growth processes initiated in the two most populous countries of the world: India and China.

Furthermore the authors underline that globalization processes do not contribute to increase inequality in the distribution of income within countries (ibid., pp. 11-13). They also maintain that the globalization debate, put forward by the so-called *global civil society*, has raised many question on the effects of globalization process regarding the problems of poverty reduction, the shift of power among groups within the national economies, the cultural transformation of countries and the environmental issues. As far as the globalization processes, according to the authors, they can contribute to respond to these challenges in a positive way.

For Collier and Dollar, in order to involve all the countries that have not yet benefited by the globalization processes, there is the need of a new round of commercial agreements. National economies must intervene also by putting into action selected policies and institutions that, generally speaking, must create an appropriate environment for local investments. In order to protect workers who do not benefit by the globalization processes some kind of *one-off* social policies must be put into operation (ibid., ch. 3).

This boundless confidence in the processes of globalization, though not unanimous, endured as a dominant view until the financial and economic crisis started in 2007. As we will see in the next section among the first authoritative critics of globalization emerges, with a great stir, an insider, Joseph Stiglitz.

2. The Criticism of Globalization

The first well-known critic of the triumphant so-called neoclassical globalization approach was Joseph Stiglitz. According to Stiglitz globalization is a process that potentially can generate a significant increase in growth and well-being in many poor countries of the world. The point then is that the advocates of globalization, namely the international bureaucrats of the World Trade Organization (WTO) and of the International Monetary Fund (IMF), systematically guided globalization for the sake of the economic interest of rich countries, and mainly for the economic interests of the United States (Stiglitz 2002, ch.1; 2003, ch.9). The charges of Stiglitz were of course well documented as he, during the 1990s, served as a member and then chairman of the Council of Economic Advisers of the President Bill Clinton and as senior vice president and chief economist at the World Bank. With his books on globalization Stiglitz explains to a wider audience the causes of the stream of protest raised against WTO and IMF, starting from the events of Seattle in 1999.

Stiglitz substantially demonstrated that the free trade liberalization process, which was invoked as the fundamental prerequisite of triumphant globalization, was not effective for the growth of poor countries, nor equitable[2]. This happened because the treaties imposed to developing and poor countries were studied in order to open those economies without reciprocity with developed countries and this process was related both to international trade and to the financial sector.

International trade is a fundamental step toward self sustained progress and any country of the world cannot even imagine to develop without increasing her capacity to produce and to export. This is probably an unquestioned aspect of the globalization process. The point is, as well explained by Ha-Joon Chang, that looking back at history of now developed countries it is possible to state that almost every country has used in the past protectionist policy measures in order to develop the national industrial sector (infant industry) and this applies to XVII century England, to France, Germany, United States, Sweden, Japan and, of course, to South Korea and China (Chang 2003, ch. 2).

According to Chang "infant industry promotion (…) has been the key to the development of most nations (…). Preventing the developing countries from adopting these policies constitutes a serious constraint on their capacity to generate economic development" (ibid., p. 10). Furthermore, developed countries, through their commercial treaties or with conditional loans, impose to poor countries a set of rules and institutions, such as the protection of intellectual property rights, financial institutions, Central Bank, democracy, efficient bureaucracy, corporate governance institutions that they did not have before becoming developed (ibid., ch. 3).

The conclusion of Chang is that the set of rules and institutions imposed to developing countries (and in the first place trade liberalization) is a perverse system of obstacles brought forward in order to prevent them to raise and develop autonomously. The point really interesting for our purposes is that for Chang, given these premises, globalization, in the version exposed in the section above, simply

[2] Stiglitz mainly referred to the *Uruguay Round* of 1987-1993 that leaded to the conversion of GATT (General Agreement on Tariffs and Trade) into the World trade Organization, Stiglitz 2002, pp. 7-9.

does not exist. There are institutions and power relationships at the international level which historically determine phases of intensification of international trade and phases of contractions. In essence, globalization is not, as on the contrary is emphasized also by Stiglitz, a phenomenon related to the possibility of economic and technological expansion of trade.

For Chang the puzzling question about the globalization processes is that

> "as a result of neo-liberal policies, income inequality has increased in most countries (…) but growth has actually slowed down significantly. (…). Neo-liberal globalization has failed to deliver on all fronts of economic life – growth, equality and stability. Despite this we are constantly told how neo-liberal globalization has brought unprecedented benefits" (Chang 2008, p. 28).

The crucial aspect of this criticism regards the dynamic of income inequality and growth at the international level. Many authors, in recent years, dealt with this subject in order to explain why the progressive integration of economies at international level produce many "negative externalities", such as the increase in income inequality and the ecological stress on the environment[3].

As far as the study on global income inequality, the most systematic analysis of this issue is the one of Branko Milanovic (2005, 2011). Contrary to the wisdom of the optimists, Milanovic shows that over the past twenty-five years, global inequality, measured both as internal inequality and as inequality between countries, has increased significantly. With regard to the first type of inequality, that is the one currently not yet well explained, the crucial point is why inequality in the advanced countries, especially the United States and Europe, after a long period of decline, has started to increase. In other words, the growth of inequality in income distribution, which is realized during the phases of industrialization, is explained by the fact that it is a physiological process that the transformation of poor economies produces a sudden social and economic stratification.

[3] For an analysis on China and India, see Bhaduri (2008).

This has happened in the past to the present advanced economies and more recently to the so-called emerging economies: China, India and Russia.

The question, however, is that the processes of globalization, at the opposite to what had been expected, did not favor the reduction of inequality and, at the same time, there has been a deterioration in the economic conditions of the poorest sections of societies, and this is true for both the developed and the developing countries.

The promises of globalization have not been fulfilled because with the expansion of the integration processes among countries, even if the income produced is increased, no process of convergence between countries has been achieved (Milanovic 2011, pp. 115-118).

According to Milanovic, the most obvious economic consequences for the process of growing inequality in the advanced countries affect the current economic and financial crisis. Deregulation of financial markets has not been the main cause of the crisis. It has helped to increase the effect of the crisis. The origin of the crisis lies in the progressive increase in inequality recorded in all countries in the last thirty years, and especially in the United States. A growing inequality means that the income of a small minority of the population increases dramatically. This income, in the case of the United States, has been poured into the financial market in search of investment opportunities and has substantially contributed to sustain the consumption levels of the American middle class which, as a result, is heavily indebted (ibid., pp. 211-214). The consequences of this process are known and will be further developed in this volume (see ch. 1).

In conclusion, on the one hand the neoclassical theory of globalization seems to be unsatisfactory because it does not explain the rise of the crisis and the persistency of poverty in many countries. The alleged convergence process was absolutely not operative. From another point of view this theory failed to see that global inequality was growing and that this process was among the causes that contributed to the financial and economic crisis of the present days.

3. A New World Bank? The Age of Doubt

The World Bank *Commission on Growth and Development*, in the words of the final report editors Michael Spence and Danny Leipziger, started its work in 2006 because “while we felt that the benefits of growth were not fully appreciated, we recognized that the causes of growth were not fully understood” (Spence, Leipziger 2010, p. xi). Furthermore “our understanding of economic growth is less definitive than commonly thought- even though advice som e-times has been given to developing countries with greater confidence than perhaps the state of our knowledge would justify” (ibid.). These statements are in sharp contrast with the optimistic and bold attitude of few years earlier. This much more cautious approach, as it is simple to guess, is due to the fact that the activities of the Commission where in few years overlapping with new unexpected events, namely the recent financial and economic crisis. Furthermore the editors of the report, on the one hand, testify that the contemporary theoretical framework regarding the processes of economic growth is much more full of unresolved questions compared with few years earlier and, at the same time, that the toolbox of the economists is almost empty.

For this last aspect, as it was remarked before the Commission, firstly by Easterly (2001) and then by Lindauer and Pritchett (2002), there was at a theoretical level the awareness of a general lack in the literature regarding the analytical explanation of development and growth processes. After the decline of the so-called season of “high development theory” of the 1950s-1960s (Krugman 1992; Hirschman 1981) there was not any “big” and consistent theory that was able to explain the development processes and the ways to guide the development policies. Eventually, if development economics was abandoned, the so-called globalization neoclassical approach did not triumph.

Then the question is: are we in the *Age of Doubt*?

For many economists who in the recent past were pretty confident of the power of the neoclassical globalization theory, the response to the question is affirmative. Anyway there is not at the moment any *convergence* in the economic theory regarding the explanation of the causes of the crisis. While Milanovic raises the problem of income inequality as the fundamental cause of the present crisis, in the 2010 report of the World Bank it is clearly stated that "the Commission believes that the crisis was a failure of the financial system" (Spence, Leipziger 2010, p. xii). Different causes require dissimilar cures so we still need to investigate which is the best way to handle the present economic situation.

There are many aspects related to the processes of globalization that need to broaden the scope of the issues under investigation and to help to understand in detail the effects of globalization on different national contexts. This volume then responds to the need to understand and deepen the study of the processes of international economic integration seen in the light of the recent economic crisis. The crisis certainly provides a strong incentive for research but, as has become clear from the review of positions analyzed above, there is not only one path of research that is able to contain all the economic and social issues raised by globalization.

An effective approach of investigation would be to look at globalization, and to the contemporary economic crisis, from a longer term perspective. This would allow researchers to interpret this phenomenon as a particular stage in the evolution of capitalism. In essence it is not possible to understand the characteristic phenomena of globalization without analyzing the historical processes that produced them. This means, above all, to investigate the role played by social, economic, and institutional aspects taken into consideration in a broad sense.

As suggested by Robert Heilbroner (1992), a broader vision on the evolution of capitalism allows us to see that the process of capital accumulation involves both aspects, success and failure. The success is measured by the improvement in the material well-being, while failure is manifested by the adverse social consequences and by the instability of the system. These processes are intertwined with each other and are essentially inseparable. In other terms, as long as there is capital accumulation, there will be also side effects (ibid. pp. 50-52).

This does not mean that the State can't intervene through policies designed to alleviate the adverse social consequences. With regards to the instability of the system, this problem is more difficult to solve because the processes of globalization have a geographical scope much larger than the field of action of national policies. Furthermore, international institutions, designed at least to watch over global processes, as we have seen above, are too oriented to the economic interests of the developed countries and, overall, are basically undemocratic.

Finally, a point on which it is useful to reflect refers to the fact that the problems of instability and the failures of the capitalist accumulation process derived from the operation of the private sector, not from the public one. For this reason, the results of the future scenarios will depend increasingly on the ability of the public sector to correct the failures and to govern international processes.

4. Content of the book

This book derives from a fortunate series of research seminars held at the University of Salento during 2011. They were devoted to the theme "Globalization and Economic Crisis". The seminars were organized by the two editors and by the Centre for Economic Studies, for the Degree Course of Political Sciences, where Claudia Sunna teaches Political Economy.

Those meetings provided a world survey of general processes of globalization together with specific analysis of regional contexts. The latter approach allowed us to see the effects of these processes in very different national contexts. The collection of all these written texts will be certainly useful to people interested in this topic.

Given these purposes the book is divided into two Sections. The first, *Facts and Theories*, is devoted to the analysis of some general concepts and processes, for which it is necessary to look at the global level of economic international relations. Chapter 1, by Toshiaki Hirai, addresses the key issue of financial globalization in order to explain how the process of integration of capital markets tends to intensify the instability of the system. In Chapter 2, Sunanda Sen looks at the controversial relation between globalization and economic development, and provides an overview of the theoretical approaches and of the effects of certain policies of globalization on developing countries. In Chapter 3, George Bitros discusses the positive effects of globalization on economic growth and underlines the importance of international trade in this process.

The second section of the book, *Case Studies*, is devoted to highlight how globalization affects the economic development in some national contexts. Toshiaki Hirai examines the case of Japan, Sunanda Sen analizes the situation in India, and María Eugenia Romero Sotelo and Juan Pablo Arroyo Ortiz study the case of Mexico.

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SECTION I

Theories and Facts

Chapter 1

Financial Globalization and Instability of the World Economy

Toshiaki Hirai

1. Introduction — Globalization

Since the mid-1980s the world has seen the development of globalization under the leadership of the US and the UK. Globalization can be summarized as "the tendency toward the market economy on the global scale". It has turned out to transform the political economy of the world dramatically, to an extent such as nobody could have expected, and it has defined the future course along which the world should proceed.

We might divide globalization into two types: "financial globalization" (FG), on the one hand, and "market system (or capitalistic) globalization" (MG) on the other. FG is the global unification or liberalization of the financial market, while MG is the multiplication of nations, on the global level, which would adopt the market system as the fundamental economic mechanism.

We may identify three upheavals which globalization has brought about to the world system over the last three decades: (i) recapture of leadership of the world economy through finance by the US and UK; (ii) collapse of the Cold War system and convergence toward the capitalistic system; (iii) rise of the emerging nations.

The first of these was caused by FG, the second and the third by MG. It was "Neo-Liberalism" (Thatcherism and Reaganomics) as a social philosophy that drew the world economy powerfully in that direction – 'leave all to the markets; government intervention in the economy will hamper its efficiency and development; the structure should be reformed in such a way that regulation be abolished as much as possible'. Promoted, backed and promulgated by the Neo-Liberalists, liberalization in the field of finance, labor and capital has been extended literally on the global scale – above all, the liberalization of finance (or FG).

In this paper, we will focus mainly on how FG has in the course of time been making the world economy increasingly unstable and volatile. In Section 2 we will explain how financial liberalization has proceeded in the US, while in Section 3 we will see how the world financial system has become unstable and vulnerable, leading up to a world economy characterized by instability. In Section 4 we will reflect upon what financial liberalization has implied in relation to the world economy. Finally, in Section 5 we will explain how the US administration has grappled with the meltdown caused by the Lehman Shock and barely managed to enact the Financial Regulatory Reform Act in July 2010.

2. U.S. Financial Liberalization —Attenuation of the Glass-Steagall Act and Enactment of the Gramm-Leach-Bliley Act

2.1 The Outline

The Glass-Steagall Act (the GS Act hereafter) enacted in 1933 had long been a dominant instrument for regulating and overseeing the US financial system. In the 1920s the USA saw financial fraudulence rampant, to the extent that President Roosevelt ascribed the Great Depression to it[4]. So it was that the GS Act was passed with the aim of imposing strict regulations on the financial institutions. It was composed of three pillars: (i) regulation of interest rates ("Regu-

[4] The Pecora Commission made a great contribution to revealing this fact.

lation Q"); (ii) separation of commercial banking from investment banking; (iii) regulation of interstate banking.

In the 1960s a movement calling for softer regulation was launched through the lobbying activities of banks eager to enter the municipal bond market. But the GS Act had worked well enough up until the 1970s, when the situation eventually changed.

In the 1970s the investment banks tried to edge into the sphere of commercial banking, providing customers with money accounts (with interest paid), including check and credit services. The role which the DTCC (Depository Trust and Clearing Corporation) played here was significant. Throughout the 1970s and 1980s computerization went ahead only in the mega investment banks, where individuals came to make transactions by means of the so-called "street names", which worked as a sort of reserve ratio in the case of the commercial banks. The investment banks were able to get new funds by exploiting them, which aggravated the commercial banks' growing impatience.

In the 1980s bills aiming at relaxing the GS Act had often been submitted to the Congress. Abolition of Regulation Q came first in 1986, followed by that of interstate banking regulation in 1995 (the Rigle-Neil Act). Lastly, the separation of commercial banking from investment banking was unlocked by the Gramm-Leach-Bliley Act (the GLB Act hereafter) in 1999.

2.2 Relaxing Separation between Commercial Banking and Investment Banking

Here we will see how the GS Act came to be alleviated and finally abolished, focusing on the separation of commercial banking from investment banking.

The movement toward relaxation might be said to have proceeded through a sequence of extended interpretations by the Federal Reserve Bank (FRB) of Section 20 of the GS Act. In December 1986 the FRB interpreted a clause in the Section which prohibits "in principle" a commercial bank from dealing in investment banking in such a way that it is allowed to do so for up to 5 percent of the total revenue, followed by the FRB's decision (spring of 1987) that a commercial bank can underwrite some securities.

Since A. Greenspan, a former executive of J.P. Morgan, was appointed Chairman of the FRB in 1987, relaxation of the GS Act was expedited through the following stages:

(i) In 1989 the FRB permitted commercial banks to engage in underwriting securities for up to 10 percent of the total revenue (the first bank thus allowed was J.P. Morgan);
(ii) In December 1996 the FRB authorized bank holding companies to have investment banks as subsidiaries for up to 25 percent of the total revenue;
(iii) In February 1998 there emerged a merger deal between the Travelers Insurance Company (the CEO was S. Weil) and Citicorp (the president was J. Lead). This should have been impossible under the GS Act, but vigorous lobbying activities developed targeting top figures such as Clinton, Greenspan and Rubin, resulting in the FRB approval of the merger in September;
(iv) The final blow came with heated agitation calling for abolition of the GS Act, resulting in enactment of the GLB Act in November 1999.

2.3 Promulgators for the GLB Act

It was financiers such as Wile and Lead, and politicians and/or academics such as R. Rubin, L. Summers (whose protégé was Rubin), Greenspan and Phil Gramm (Republican Senator) who worked as the promulgators for the GLB Act.

Summers and Greenspan were responsible for drawing up the GLB Act, alias "the Citi-Group Approval Act". Rubin, who resigned as Secretary of the Treasury in July 2000, was welcomed as CEO of the Citi-Group. While he was there, he induced the Citi-Group to embark on risky investments such as the CDO (Collateralized Debt Obligation)[5].

Gramm was also involved with enactment of the Commodity Futures Modernization Act of 2000 (the CFM Act hereafter), which gave momentum to moves to legalize the future trade of energy and the credit default swaps (CDS hereafter).

Prior to this, B. Born, chairperson of the Commodity Futures Trading Committee (the CFTC), who was worried that the OTC (Over-The-Counter) Derivatives (esp. the CDS) had been transacted on an ever larger scale, evading supervision of the financial authorities, insisted on the need for supervision. Her move, however, came up against harsh opposition from Greenspan, Rubin (the then Secretary of the Treasury) and Summers, who had promoted relaxation of the GS Act. It was they who reversed the direction and succeeded in enacting the

CFM Act. Wendy, Gramm's wife and chairperson of the CFTC under the Reagan and the G.H. Bush Administrations, also worked hard for the CMF Act, thanks to which she was to be welcomed by Enron.

The salient feature of the CFM Act, known as the so-called "Enron Loophole" (the future trade's exemption from supervision), lies in "the single stock future" being allowed. This was to enable higher leverage and more speculative activities (the Act is held responsible for the California Electricity Crisis in 2000-2001).

Enron had been very much involved in derivative dealings in the 1990s. In 1999 it set up "Enron Online" and greatly extended derivative dealings. It was subsequently to be exposed for continued fraudulent accounting and was forced into bankruptcy, setting the scene for the so-called "Dotcom Bubble" to burst.

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[5] Incidentally, Geithner, the Secretary of the Treasury (Summers was a protégé), was president of the FRB of New York. In September 2008 he forced the Lehman Brothers to go into bankruptcy, and yet bailed out the Citi-Group with the TARP fund.

Phil Gramm[6] was thereafter welcomed as executive by UBS[7], where he is reputed to have played a central role in its extensive involvement with the CDS.

3. The Instability of the World Financial System

How are we to evaluate the influences on the world economy resulting from financial liberalization or globalization? They can be approached from both affirmative and problematic viewpoints.

Enabling capital to move to the regions where it can obtain higher rates of profit, FG has contributed to generating vigorous economic growth such as would otherwise have been impossible in these areas.

Leaving further considerations from this affirmative viewpoint to a later date, we will focus here on the problematic aspect – the instability of the world financial system as cause of the collapse of the world economy. Firstly we will take the rise of the Shadow Banking System, followed by two examples of turbulence.

3.1 The Rise of the Shadow Banking System

Gaining momentum in the 1980s, FG ingenerated the “Shadow Banking System” (SBS hereafter). The US financial system, which had so far been supervised by the FRB under the GS Act of 1933 with the purpose of keeping the speculative activities of banking business under control, began to enjoy more relaxed conditions subsequent to the above-mentioned financial liberalization, spawn-

[6] Gramm ran for Republican nomination in the 1966 presidential election. In the 2008 campaign for the Presidency he was among McCain’s principal supporters. According to a certain source, he would have been the Secretary of the Treasury if McCain had been elected as President.

[7] In October 2008 the UBS, which suffered a huge loss, not only received public money (to the tune of 6 billion Swiss francs) from the Swiss government, but also handed over the bad assets (amounting to 72 billion Swiss francs) to it.

ing a whole series of new financial institutions such as hedge funds and private equity funds, which lend themselves freely to speculative dealings without supervision by the financial authorities. Working out various kinds of securitized papers such as the MBS, the CDO and the CDS and using leverage, these institutions came to be involved in risky speculative dealings in the global financial markets. Having witnessed their surprisingly high rates of return, the commercial banks, which had been kept under control by the FRB, found their way into the SBS by means of an off-balance technique, the product being "Special Investment Vehicles" (or SIV).

Thus, as the years went by the SBS grew bigger and bigger, to such a degree that the share of conventional banking shrank ever smaller, making the world financial system increasingly unstable and volatile.

Excessive FG had often precipitated the world economy into critical conditions, and yet the world had managed to avoid any great catastrophe. Eventually, however, FG led to the Lehman-shock in September 2008, which set the world financial system as well as the world economy plunging precipitously.

The resulting situation prompts the following questions: could the rise of the SBS really have been desirable, and indeed indispensable to the development of the world economy? What justification can there be for the layered securitized papers (see below) and the financial institutions' speculative activities free from any supervision? To what extent can the financial engineering be justified in terms of improvement and/or growth of the capitalistic system?

Leaving these questions to Section 4.2 below, here we will take two examples of economic instability as caused by excessive FG: the Asian financial crisis in 1997-1998 and the subprime loan crisis of 2008, which see the US, the EU and Japan still in search of the way out[8]

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[8] As examples of serious financial crises which occurred in the US (albeit having no influence abroad), we may mention the S&L crisis (around 1990 (and the burst of the Dotcom Bubble (around 2001; Enron is emblematic there).

3.2 Two Examples

The Asian Financial Crisis — The crisis of 1997, which started in Thailand, was caused by speculative activities in hedge funds. Thailand, which adopted the dollar-pegged system, began to suffer from a sharp drop in exports because of the appreciation of the dollar (and thus of the baht). Hedge funds, seeing the opportunity for speculation, continued to sell off the baht, which finally forced the Thai Government to devalue it. The Thai economy, which had so far gone on achieving a high rate of economic growth thanks to dollars borrowed in the short term, plunged into a serious depression which abruptly increased the debt in terms of the dollar. The depression rapidly propagated to Malaysia, Indonesia and so forth.

The hedge funds' speculative activities then turned to target Russia in 1998. In 1991 the Soviet Union had disintegrated into several nations, the largest being Russia. President Yeltsin went ahead with transformation of the Russian economy into a capitalistic system at a breakneck pace – the so-called "shock-therapy method". The result turned out to be devastating, causing high inflation and severe unemployment, as well as fiscal crisis in 1997. The Russian government was forced to collect the necessary revenues through the issue of national bonds. Thus it was Russia, sunk in a very fragile and chaotic situation, that the hedge funds targeted. Russia failed to maintain the ruble, and was forced to declare default for the national bonds.

Now came the turn of a hedge fund named "Long Term Capital Management" (LTCM hereafter), which continued to buy the Russian bonds. It gloried in its two Nobel Laureates for Economics (for the "Black-Scholes Equation" determining option prices) as co-founders. Although it had only 150 employees, it gained such a high reputation due to its initial startling success that major banks from all over the world were willing to hand out blank checks. Around 1998 LTCM, a neutral-type hedge fund, came to manipulate 100 billion dollars and to take a position of 1000 billion dollars.

Due to the Russian bond default, however, LTCM suffered heavy loss. Suddenly there emerged a very real possibility that, if the LTCM were left as it was, the world would plunge into a formidable financial crisis. It was in September 1998 that the Federal Reserve Bank of New York (the then president was T. Geithner) asked the Wall Street megabanks to bail out LTCM. Thanks to this prompt action the world economy managed to avoid an impending crisis.

The Subprime Loan Crisis— This crisis erupted in September 2008. Since 2005 high interest rate mortgage loans had been made, targeting the low income earners (the so-called "subprime loans"). The financial institutions bought them up, and issued MBSs (Mortgage-Backed Securities) with them as collateral. Then new types of securities were issued one after another, mingling other loans such as car loans, credit card loans and so forth as collateral. Thus the US economy came to be filled with multi-layered securities ("securitized papers"), which were duly certified by rating agencies, such as Moody's, as definitely safe securities (80 percent of the securitized papers based on the subprime mortgage loans were ranked as AAA), and sold all over the world. The financial institutions eventually went as far as issuing subprime mortgage loans without any assessment (the so-called "Ninja Loans"), and, based on them, set about structuring layered securitized papers. Thus the negative concatenation went on. It was on the occasion of the Lehman Shock that this fragile monetary and credit structure collapsed, plunging the world economy into deep depression.

4. "Financial Liberalization" Considered

As explained above, financial liberalization proceeded with the impulsion of financial capital toward liberalization as catalyst. It was a movement led by: (i) the US commercial banks, eager to break out of the conditions imposed by the GS Act; (ii) the competition of the above banks with the US investment banks which, free from regulation, saw rapid development; (iii) the US government, which again wanted to hold the world financial market as well as the world economy in the palm of its hands.

Motivated with this impulsion, the leading actors such as Rubin, Greenspan, Summers and politicians like Gramm made great efforts to attenuate the GS through extended interpretations of Section 20 and finally succeeded in getting through the GLB Act as well as the CMF Act.

4.1 The Geopolitical Significance

Financial liberalization accorded well with the US government's desire to regain world hegemony in the economic scene. The US Administrations which had suffered miserable economic performance throughout the 1980s came to think that finance could be a key to regain and extend US influence over the world economy. The "Washington Consensus", adopted by the IMF and the World Bank, as well as the "Shock Therapy" method, adopted by the former members of the Soviet Bloc, with US economists as advisers[9], also accorded with the financial liberalization movement.

These movements, moreover, derived strong support and credibility from the intellectual authority related to Neo-Liberalism, financial engineering, and the New Classical School as well as ideologies such as Neo-Conservatism and the Christian Fundamentalism. To say nothing of these ideologies, Neo-Liberalism also took on a very authoritarian stance, quite different from its ostensible one. As the progenitor of "freedom", the Neo-Liberalists did not hesitate to interfere with foreign countries where freedom, as they conceived it, was judged to be lacking, through either the "structural adjustment program" or military operations. In this sense, Neo-Liberalism contains a sort of "Power-ism".

In terms of political dynamics, furthermore, these movements can be said to have proceeded hand in hand with Cleptocracy – the "quid pro quo" ties between financiers and the financial authorities.

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[9] The most famous, and indeed, notorious was A. Schleifer, Professor at Harvard University (his protégé is L. Summers), in the case of Russia.

4.2 The Economic Significance

What kind of economic significance will financial liberalization be seen to have?

It constitutes an extension of the markets in which the financial institutions can raise funds to have at their own disposal (where securitized papers are structured, accompanying leverage), always pursuing speculative profits by means of the funds thus obtained. Indeed, in some cases the pursuit of profit has been practiced to such a degree as to incur moral hazard.

Hedge funds have targeted weak and fragile countries, mounting speculative attacks to make huge gains with no concern for the considerable damage to the countries concerned, ascribing the defects and failures to their economic systems. In recent years these attitudes have become blatantly evident. “Finance for finance’s sake”, or speculative activities without any regard for the real economy, can be characterized as “autotelism” on the part of financial capital, far from the original role which finance should play — the role of providing the financial activities required to make the real economy grow, and making the market economy run smoothly. Thus we see the phenomenon of real economy caught up in speculative waves.

The enlargement of the SBS was also a product of the activities of governments under the leadership of the US administration, which means some divergence from the original role which each government should play — the pursuit of its own economic growth. Any government should be independent of the financial community, implementing its own policies and placing top priority on the well-being of its people. In the movement aiming at financial liberalization, in fact, various governments including the US government have gone hand in glove with the financial community at the cost of a stampede of hedge funds, the emergence of multi-layered securitized papers and a catastrophic meltdown.

5. The Financial Regulatory Reform Act

The instability of the world economy recently witnessed appears to be attributable to the enlargement of the SBS: if we are to stabilize the world economy, therefore, we need to bring it under the control of the financial authorities. This is a point recognized by the Obama Administration.

5.1 How the Story Went in the US

Obama's Financial Regulatory Reform Proposals **—** It was in June 2009 when President Obama made public the outline of his financial regulatory reform proposals, aiming at repeal of the GLB Act and modern-day resurrection of the GS Act.

The central pillars are: (i) enlargement of the FRB, which is to work not only as a central bank but also as an institution to oversee systemic risk; (ii) creation of the Consumer Financial Protection Agency (CFPA), to guard consumers from financial abuse and fraudulence.

Through these institutions dealings in securitized papers, financial derivatives, futures and so forth were to be on open and clear markets, while the activities of hedge funds, investment banks, rating agencies and so forth could be overseen. Thus the proposal aims at scaling down, if not abolishing, the SBS.

The Bailout and Early Recovery of the Megabanks **—**First and foremost, the Wall Street megabanks were rescued through bailout with huge sums of public money[10].

The story does not end here. They were soon able to make immense profits by investing gigantic volumes of money obtainable with both the FRB's zero interest rate and quantitative easing (QE) policy, in the emerging nations (such as China, Brazil and India)

[10] Funded by the TARP (the Troubled Asset Relief Program), which was hastily proposed, and was to be used in a very ambiguous way by the Bush Administration.

through the so-called "zero carry trade". Having repaid the public money to the government, the megabanks were to start a fierce battle aiming at blocking Obama's financial regulatory reform[11].

The Growing Perception of Unfairness— Contrastingly, in spite of the FRB's easy-money policy, the US real economy cannot be said to have made much progress towards recovery. Major worries for the American people include, among other things, the continued high unemployment rate, the rapid increase in arrears and foreclosure due to the bust of the housing market, which has also driven many local banks into bankruptcy (the number reaching a record high since the S&L crisis in 1992). The credit crunch by the local banks, in turn, has aggravated the real economy.

The perception of unfairness has grown among the public, for the Wall Street was instantaneously bailed out (by the Bush Administration) while the Main Street has remained stagnant (in spite of the Obama Administration's strenuous efforts).

5.2 The Dodd-Frank Act

The Process — After public announcement of Obama's financial regulatory reform proposals in June 2009, deliberations in the two houses proceeded very slowly.

On December 11, 2009 the financial regulatory reform act (the Wall Street Reform and Consumer Protection Act) got through in the House of Representatives. However, the Senate version, which was first laid out as a discussion draft in November 2009, was to proceed along a very difficult road thereafter. Leaving the details to my other paper[12], let us here summarize the process in the Senate:

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[11] As representative of the lobbyists criticizing financial regulation, we may mention the American Bankers Association, while in support of it we have an example in the U.S. Public Interest Research Group.
[12] See Hirai (2010).

(i) In May 2010 the Dodd Act (the Restoring American Financial Stability Act) was deliberated.
(ii) The deliberations continued for three weeks. On May 21 at long last the Dodd Act was passed with some slight modifications.
(iii) The Conference Committee was then set up to unify the House and Senate versions. After a few weeks' deliberations, the committee report was adopted.
(iv) On June 30 the Dodd-Frank Act was passed in the House, while on July 15 it finally got through in the Senate.
(v) On July 21 the Act was ratified with President Obama's signature.

The Gist of the Act — The Dodd-Frank Act covers the following.

(1) The Consumer Financial Protection Agency (CFPA).
This is to be set up within the FRB, but should remain independent. The director is to be nominated by the President (this reflects some compromise between the House version and the President's view).

During the subprime boom many financial institutions made mortgage loans to people on low incomes without any serious screening. In consequence, when the bubble burst a great many people were rapidly driven into default and foreclosure. It is in order to prevent this state of affairs from recurring (that is, to prevent consumers from being cheated and forced to conclude unfair contracts) that the CFPA is to be set up.

(2) Volcker Rule
This was first advocated by P. Volcker in January 2010 and supported by Obama, and was incorporated into the Act. The rule aims at prohibiting commercial banks from dealing in so-called "proprietary trading", for it would expose the depositors' money to risk through speculative activities by the banks[13].

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[13] This September JP Morgan and Goldman Sachs decided to close the proprietary trading section, heeding the Volcker Rule.

(3) Lincoln Provision
This provision was first adopted by the Senate Agriculture Committee chaired by B. Lincoln in April 2010 and was incorporated into the Act. It aims at making derivative transactions fair and transparent by abolishing Over-the-Counter (OTC) derivatives and creating an open market[14].

(4) Establishment of a committee to prevent possible systemic risk
The committee is to be composed of nine members headed by the Secretary of the Treasury.

(5) The president of the FRB of New York is to be appointed by the US President.
The aim here is to block influences from the Wall Street.

(6) In the case of megabanks running into bankruptcy, clearing and dissolution should be carried out smoothly with the fund collected from the financial industry.

In short, the "TBTF" (Too Big To Fail) idea should be swept away. The megabanks have got used to assuming that because they are huge the government will never fail to rescue them in the event of their failure. Otherwise the economy as a whole, they think, would be exposed to serious crisis. Thus they are likely to venture upon impossible speculative activities – and all this adds up to serious moral hazard.

Challenging the TBTF, the provision aims at clearing financial institutions on the brink of failure through the self-responsibility of the financial industry rather than with taxes.

It is estimated that it will take a year and half for the Dodd-Frank Act to be implemented. Each section needs interpretation, so

[14] Recently the yields gained by hedge funds have shown some decline. Wary of risks, investors are now tending to concentrate their resources in large funds rather than small ones.

there will be confrontation on it. Lobbying activities are very influential and might change the nature and the course of direction.

Moreover, should other countries – including the EU (with the UK) – fail to follow suit, the aim of the Dodd-Frank Act will be thwarted. For finance has been developed on the global scale, so any loopholes will remain gaping. If the US intensified regulation but other countries did not follow suit, the financial institutions would continue risky speculative activities, shifting their headquarters to the more easy-going countries.

And yet the Dodd-Frank Act should be welcomed, for this will be the only feasible and effective path which could lead to financial regulation on the global level.

Worrisome Present Situation — As of today we need to bear in mind the following facts of the US economy. Although the need to keep the activities of the financial institutions under the control of the financial authorities has been repeatedly urged since the Lehman Shock, it was not until July 21, 2010 that the Dodd-Frank Act was at long last enacted – just a few months ago. It will take another year and a half, moreover, for the Act to be effectively implemented. This means that so far virtually no regulation has been imposed on the SBS system.

The Wall Street megabanks were rescued by the government and made huge profits through the dollar carry trade: scandalously enough, these profits were then distributed among the executives who, by contrast, have shown no interest in helping get the Main Street back on its feet.

These states of affairs have infuriated the common people with the impression that all that the Administration and the FRB have done so far has been to rescue the Wall Street, while leaving them in the lurch. Such anger might appear all the more justifiable on recalling the barefaced personnel adhesion among the FRB, the Treasury and the megabanks.

The US society faces the potential risk of serious conflict between the two groups — the mega financial community and the masses.

In spite of the serious difficulties President Obama came up against, he finally succeeded in putting through the Dodd-Frank Act. This is a great achievement, although it amounts to only one step forward. The real test of its success hinges on the implementation from now on.

In this regard what is worrying is the fact that the approval rate for the Obama Administration has been sharply falling, mainly because it has not succeeded in reducing the high rate of unemployment. So at present the Republican Party is expected to win the midterm election in November. If so, the implementation of the Dodd-Frank Act will entail great difficulties. Even today the Administration has some difficulty in deciding the top-ranking posts of the new institutions to be set up by the Act. The difficulty will be much greater after the election.

6. Conclusion

We have examined financial liberalization or globalization, and the increased instability of the capitalistic system brought about by it, focusing on the USA as a center of the world economic system. We cannot imagine continuance of the capitalistic system without finance. And yet there is a danger that serious meltdowns will be repeated if the financial system is left as it is. The future of capitalism will hinge upon how the "right capitalism" can be maintained and developed, harnessing this restive horse.

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Chapter 2

Globalization and Development

Sunanda Sen

1. Introduction: Do we view Globalization as old or new?

Globalization can be traced back to its old incarnation in terms of an imperial order, when colonies were linked to the ruling nations both politically and along economic channels. However, the new pattern of globalization which has evolved over the post Second World War period has been integrating countries with globalised markets and fast communication channels which operate beyond the authority of sovereign nations. Markets in different parts of the world have opened up steadily in response to the mainstream doctrines which has been influencing policies in most countries. Simultaneously, technology has minimized the barriers across nations with speedy communications as well as blending of cultures. Globalization today is a far more sweeping force to connect nations as compared to the earlier pattern of linking countries via trade, financial flows and political subjugation. While political domination was a major aspect in the earlier pattern, globalization today has brought in greater socio-economic disparity which, in the countries with a representative governments, has led to open discontent in society.[1]

In today's globalization the geo-political significance of select advanced countries has been crucial in determining the pattern of international interactions, which include trade, finance and even strate-

[1] Sen, 2007; McGrew and Held (2007).

gic concerns. Influence of the powerful advanced economies on multilateral institutions has played a part in determining policies which favor the more powerful nations in the advanced region.

We can identify the following four aspects as the prominent features of today's globalization.

- ✓ Market driven policies with faster pace of capital and skill intensive innovations.
- ✓ Global integration of markets for goods, services, technology and finance.
- ✓ Dominance of finance in global and national policies.
- ✓ Staggering inequality within and across nations.

2. Unfulfilled promises of Mainstream Economics with the overpowering market

Let us here deal with the market-driven policies which drives globalization today. In terms of the logic postulated in free market theories, voluntary exchange by rational actors in the market achieves 'efficiency', providing mutual gains in trade and exchange. With market access production achieves economies of scale and competitive edge *vis a vis* other producers.

One can, however, detect the limiting assumptions behind these theories. Those include, among others, perfect competition; the full utilization of resources including labor; complete information to all in the market; the distribution of product according to the contribution to output in terms of marginal product of factors deployed in production. None of these assumptions remain valid in the context of the actual functioning of markets.

It is thus not a surprise to witness the failure of free markets to end unemployment, poverty and excess capacity. With inequity and instability one also notices large-scale displacement of labor, especially with technological advances. Investment today is often guided by financial gain (most often on financial assets) rather than by physical productivity in the real sector.

3. Markets in economic theory: Three Variants

To deal with markets in theory, it is useful to distinguish the following three variants:

The neo-classical theory bases itself on methodological individualism, which assumes the capacity of rational individuals to fulfill the maximum benefits by operating in self-interest, which in turn ensures common good for all who are operating similarly. Mainstream theory provides an uncritical acceptance of the ability of markets to attain growth with efficiency which achieves optimum production, consumption and distribution, in terms of what is defined as the Pareto optimum. Accordingly expansion of markets can also be a cure-all for slow growth or lack of development.[2]

Alternately, markets can be viewed as an institution under capitalist systems, which is both dispensable and at best subject to regulation by authorities. In terms of orthodox Marxist positions, the market is necessary but not sufficient to ensure capitalist production. This is because a capitalist system is considered to based on wage labor, exchange economy and a process of accumulation.

In other versions of Marxist analysis, markets, providing channels of exchange, have viewed as sufficient for capitalism. A view as above dominates the World System theories offered by Gunder Frank and Immanuel Wallerstein,[3] both of whom trace the beginning of capitalism to the earlier centuries of mercantile trade.

The Marxist theory of markets under capitalism also include the Dobb-Sweezy mode of production debates on transition from feudalism to capitalism. In this context some have drawn attention semi-feudal or semi-capitalist modes of production in the context of the developing countries, thus extending the analysis to cover the region which has encountered the rapid advances of markets under globalization. The above extends to other versions of Marxist readings, notably that of Samir Amin[4], on markets under globalization.

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[2] See for a critique, Sen, 2005.
[3] Frank, 1976; Wallerstein 1980.
[4] Amin, 1977.

This includes the notions of "Peripheral capitalism" in developing countries, one where the co-exists with non-market activities.

We now have a look at notion of markets when viewed beyond standard tools of economic theory, as in Karl Polanyi. Polanyi's *Great Transformation* spells out the "double movement" under capitalism. It relates to the expansion of market relations and the ensuing reactions of society to protect itself from the consequences of the very operation of the market; as an allegedly self-regulating mechanism. This ensures the dominance of global markets' culture on social relations or the fabric at large. The latter pervades family, community and all social relations. In effect expansion of markets proceeds with dispossession, displacements and degradation of people. As a consequence the market and even the state are both disembedded from society. As put by Polanyi[5], "Yet simultaneously a countermovement was on foot. This was more than the usual defensive behaviour of society faced with change; it was a reaction against a dislocation which attacked the fabric of society, and which would have destroyed the very organization of production that the market had called into being" .

Despite its relevance in understanding the social processes under globalization, Polanyi's theorization on markets has been ignored by Marxists as well by mainstream theorists.

4. Free Markets in operation: liberalized trade in goods and services[6]

Trade liberalization in developing countries, was initiated by the International Monetary Fund (IMF) in terms of the Structural Adjustment Programs (SAP). In 1980s these programs were considerably intensified with the tariff cutting rounds (meetings) of GATT (General Agreement on Tariffs and Trade) and later of the WTO (World Trade Organization), especially in terms of the provisions

[5] Polanyi, 1957.
[6] Sen, 2005

under the Trade Related Aspects of Intellectual Property Rights and Trade Related Investment Measures (TRIMs). In general the developing countries have been grossly disillusioned with the functioning of these multilateral tariff-cutting institutions, especially on issues of trade restrictions on textiles and agricultural subsidies in advanced economies. Moreover, the end of national patent regime which started with product patenting has considerably dampened the national R&D (Research and Development) activities in the developing nations. The new trade regime under WTO has also pushed up prices of pharmaceuticals while encouraging Genetically Modified food in these areas.

In a similar tone, smaller countries in advanced areas also were faced with lesser advantages during the new regime, a culmination of which, along with other factors, has been the current EU crisis.

5. Free trade in technology and services[7]

The General Agreement on Trade in Services (GATS) under the WTO is considered to provide level playing field to service providers from abroad, a move which, as claimed by WTO, is in the name of competition policy and efficiency.

While the measures under the GATS were responsible for wide-ranging innovations in Information and Communication Technologies (ICT), micro-biology, communications, power and construction, there has been an asymmetric impact vis a vis the developing and advanced nations. Thus as it has been pointed out, technology is not a "free public good' and "world is not flat". One does not observe a process of 'learning by doing', especially for late-comers in the industrialization process, unlike what is claimed in endogenous growth theory.

Services which are under the scanner of liberalization include wide-ranging spheres which include banking, insurance, transports,

[7] See Sen, 2007

railways, electricity, gas, telecommunications, health and education. Many of these are in the nature of public goods, which demand state intervention, especially in the developing economies. Liberalization and privatization, as in the new trade regime, hamper the process.

Issues of further liberalization of services are in the agenda, in terms of Non Agricultural Market Access(NAMA), Singapore Issues[8] and the Doha declaration[9] of the WTO regime .

6. Financial Liberalization

Finally, we look at the new regime of financialisation in deregulated financial markets. Initiated by IMF and World Bank through loan conditionalities, liberalization of financial markets today has a wider appeal to policy makers in different parts of the world economy in terms of the Washington Consensus.[10]

Implementation of these policies first of all has churned the realm of speculation-led activities in financial markets with shadow banking, generating myriads of derivative instruments. Besides, these policies also have led to concentration of wealth within as well as across countries. It may be recalled here that Foreign Direct Investment (FDI) flows from advanced countries today are more than five times those originating from the developing countries. Half of those

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[8] Four issues introduced to the WTO agenda at the December 1996, Ministerial Conference in Singapore: trade and investment, trade and competition policy, transparency in government procurement, and trade facilitation.

[9] http://www.wto.org/english/thewto_e/glossary_e/singapore_issues_e.htm

[10] The term Washington Consensus was coined in 1989 by the economist John Williamson to describe a set of ten relatively specific economic policy prescriptions that he considered constituted the "standard" reform package promoted for crisis-wracked developing countries by Washington, D.C.-based institutions such as the International Monetary Fund (IMF), World Bank, and the US Treasury Department. See http://en.wikipedia.org/wiki/Washington_Consensus

FDI flows from advanced economies comprises Mergers and Acquisitions (M&A) which further adds to concentration.

Opening up of financial sectors by developing countries also tends to affect their national autonomy in the management of fiscal, monetary and exchange rate policies. Often such policies are guided by the immediate concerns relating to the external sector rather than to the need of the domestic economy in terms of growth and employment.

In conclusion, opening of markets and the integration of countries in terms of globalization has more to do with problems created to countries, especially in the developing region, rather than providing a panacea for rapid and efficient growth.

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Chapter 3

In defense of Globalization

George Bitros

1. Introduction

In this short paper I pursue three tasks. First I explain why so many economists, in my view the overwhelming majority of them, support the general proposition that trade is beneficial to all countries involved in bilateral and/or multilateral exchanges. This I think is a very important point because, of those who are against globalization, the non-economists do not know that ultimately it is driven by the benefits that it brings, particularly to those that lag behind in the scale of economic development, whereas the economists invoke considerations that are contradicted by facts. My second task is to highlight the forces that have been unleashed by globalization and explain why globalization is unstoppable. In this regard, what I claim is that, as long as the worldwide diffusion of information cannot be controlled by any single country, no matter how powerful, globalization will proceed at an accelerating pace. Finally, my third task is to look into the logic of the criticisms that have been raised against globalization and try to make sense of their consistency or lack of it.

2. The benefits from international trade

To understand the source of the benefits from international trade, I will employ an example of extreme simplicity. In particular, I will strip it from all complexity by appeal to three assumptions. The first of them is that there are two countries, say, 1 and 2, which are alike in all respects except one. This implies that, whereas the countries have the same institutions, the same technology for producing, say, goods X and Y, and the same tastes, their endowments in terms of natural resources differ. The second assumption has to do with the so called transformation curve, which defines how many units of good Y must country 1 (2) give up in order to free up enough resources to produce one unit of good X. Lastly, the third assumption is that the two countries live isolated from each other.

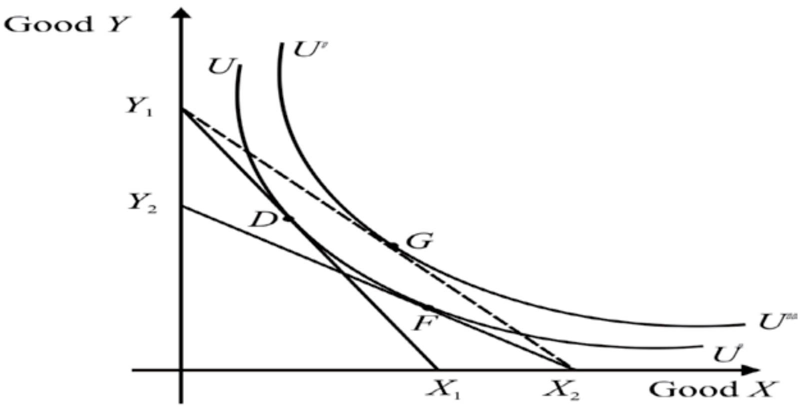

Figure 1

In light of the first assumption regarding the difference of the two countries in natural resources, I will assume for the moment that their transformation curves are linear with different slopes and depict all the above in Figure 1. Line Y_1, X_1 gives the transformation curve of country 1, line Y_2, X_2 gives the transformation curve of country 2, and UU′ is the preference ordering of the two goods in the two countries.

Theorem I: *If the transformation curves are linear with different slopes, the countries specialize completely in the production of that good in which they are most efficient.*

At this point remember the assumption that the two countries live in isolation. If so, countries 1 and 2 will reach equilibrium in the demand and the supply of goods X and Y at points D and F, respectively. At these points they will enjoy the utility indexed by the indifference curve UU′. Next, let us assume that all barriers to trade are eliminated and the countries start to rethink their opportunities. Before very long they will discover that they can increase their material welfare by concentrating in the production of the good in which they are most efficient and then trading it for the quantities they desire to have from the other good. In particular, they will discover that the technologies at their disposal, as reflected in their transformation curves, permit them to proceed to a state of complete specialization, in which country 1 produces only good Y in the quantity Y_1 whereas country B produces only good X in the quantity X_2 in line with the theorem below. Moreover, the countries will discover that it is to their great benefit to trade because they can increase their material welfare by moving to the utility indifference curve U′U″ at point G. This proves the basic proposition that the driving force behind international trade is the benefits that accrue from allowing each country to specialize in those goods they can produce most efficiently and trade them in some quantities in international markets to acquire the goods they wish to have.

The validity of this proposition has been investigated in the relevant literature under a variety of different assumptions and in general it has been found to be quite robust. To give you an example, consider the case in Figure 2, in which the two countries have different tastes as well as transformation curves. Soon after they realize that they coexist, the citizens in the two countries will discover that the prices of the two goods are different in the two countries.

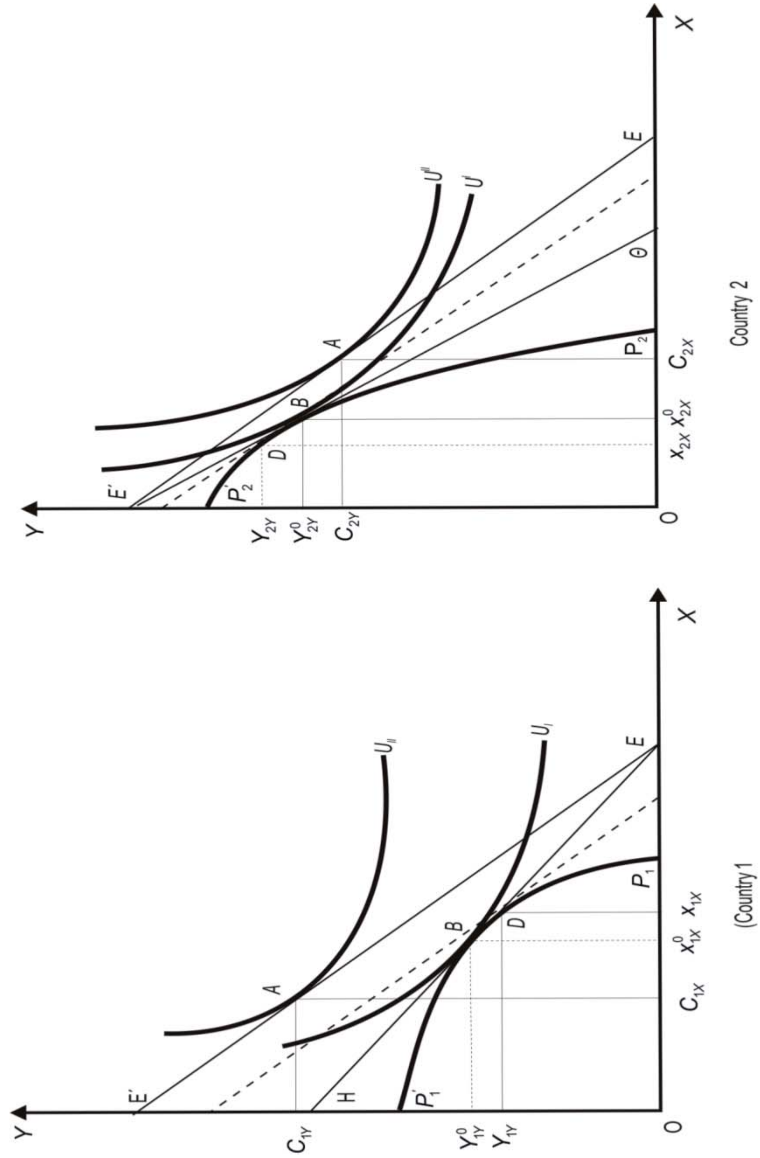
Y
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Figure 2

This realization will occur to them because of the difference in the slopes of curves $C_{1Y}E$ in country 1 and $E'\Theta$ in country 2. So they will start trading with the cheaper goods flowing to the countries where they are more expensive. In particular, country 1 will start importing good Y and exporting good X, with country 2 doing the opposite, until equilibrium is established at point A in Figure 1a and 1b. At those points the prices of the two goods in the two countries will have become equal and there will be no more advantage in changing the quantities of goods consumed, produced, and traded. Observe though that equilibrium is established at a level of material welfare that the two countries could not reach without international trade. This proves again the claim that international trade is beneficial to the participating countries.

Finally, to corroborate further the benefits from trade, let me refer to a few powerful theorems which are scarcely, if at all known, to critics of globalization. The first is the one immediately below.

Theorem II: *If: 1) countries A and B have the same technological know-how; 2) their production technologies are characterized by constant returns to scale; 3) country A is abundant in one input and country B is abundant in another input; 4) full competition reigns in all markets, and 5) each country produces both goods (i.e. there is no complete specialization), then through international trade the prices of production factors in terms of purchasing power become equal in both countries.*

It is known as the theorem of factor price equalization and it is magnificent because it suggests that if the five assumptions hold, immigration of workers and the transfer of capital from one country to another are unnecessary. That is, by itself the movement of goods through international trade equates the value of marginal product of each productive factor in all its international uses. Two more theorems are:
Needless to say, these theorems constitute only a small sample of the propositions that have been worked out to highlight the benefits of and the implications for the countries involved in international trade.[1]

Theorem III: Assuming that the five assumptions in Theorem II hold, in the presence of international trade, the country which is abundant in one productive factor produces relatively more of the good which is intensive in that factor, and vice versa.

Theorem IV: If the five assumptions in Theorem II hold and at the same time preferences in both countries are similar and homothetic, the country which is abundant in one productive factor exports that good which is intensive in that factor.

At this point one may ask: if the case is as predicted, say, by Theorem II, why do we observe so significant flows of labor and capital moving from one country to another? Or, expressed in another way, if international trade does have the suggested benefits, why

[1] For more details, see, for example, Brems (1968).

do we need globalization in the form of movement of labor and capital from one country to another?

The answer is that globalization is a process that retains for the countries the benefits of international trade in an environment where some or all of the five assumptions mentioned above are violated.

For an example consider the assumption that all countries have the same technological know-how. We know that this is not true and that is why capital leaves from developed and goes to developing countries. By moving there it brings new technology where it is needed and maintains the process of diffusing benefits on a world wide scale.

If after the above explanations one is unwilling to concede that international trade and globalization hold significant economic benefits that could not be had by the countries involved if they lived in isolation, that one is like the agnostic in the novel *Brothers Karamazov*. In that novel Feodor Dostoyevsky writes that there are people who may climb seven heavens, see the god and yet upon returning to the earth they testify that they did not see him.

3. Why globalization is unstoppable

Even a cursory scanning of the relevant literature would suffice to reveal that globalization is driven by the processes that are depicted in Figure 3.[2] So let me explain how they work and why it is practically impossible for any country, no matter how powerful it may be, to stop their diffusion.

[2] See, for example, Cullen, Parboteeah (2008).

Figure 3

4. Disintegrating borders

National borders have been always a significant impediment to the open economy. The reason is that they translate into trading costs in the form of differences in the export-import institutions, tax regimes, currencies, etc. However, more precipitously than in any previous period, nowadays countries adopt initiatives to integrate into the world economic community by reducing willfully economic barriers. That they do so is corroborated by many indices. One such index is the number of countries that participate in the World Trade Organization (WTO). In this regard it may be noted that membership in this organization has come to be considered a *sine qua non* for any country that aspires to rapid economic development. Another index is the explosive increase in the regional trade agreements. For example, whereas in the early 1990s there were around 70such agreements, by 2000 their number had increase to 200. Lastly, since we live in Europe, we must not forget its remarkable evolution from a customs union in the 1960 to a monetary union more recently.

The last example gives me the opportunity to add a further remark. This has to do with the nature of the particular borders that disintegrate. Many who object to globalization are afraid that it erodes the very foundations of the nation-state as a distinct institution of the prevailing world order. Their view is correct in the context of the European Union, where the participating nations willfully shed national powers on the prospect of taking part eventually to a United Federation of Europe. But this is not the case in general, because the borders that disintegrate are the economic ones, not the political, and there is no obvious reason why there cannot emerge in the long run an integrated world economy with distinct and totally sovereign nation-countries.

5. Growing cross-border trade and investment

Figure 4 shows two time series. The thick red line gives the percentage annual change in the international trade flows, whereas the thin black line gives the annual growth rates. From them we observe that the former series moves around an upward trend, whereas the trend of the later series is horizontal.

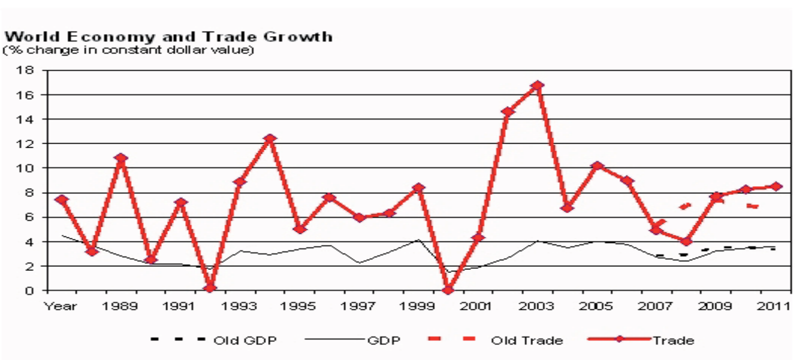
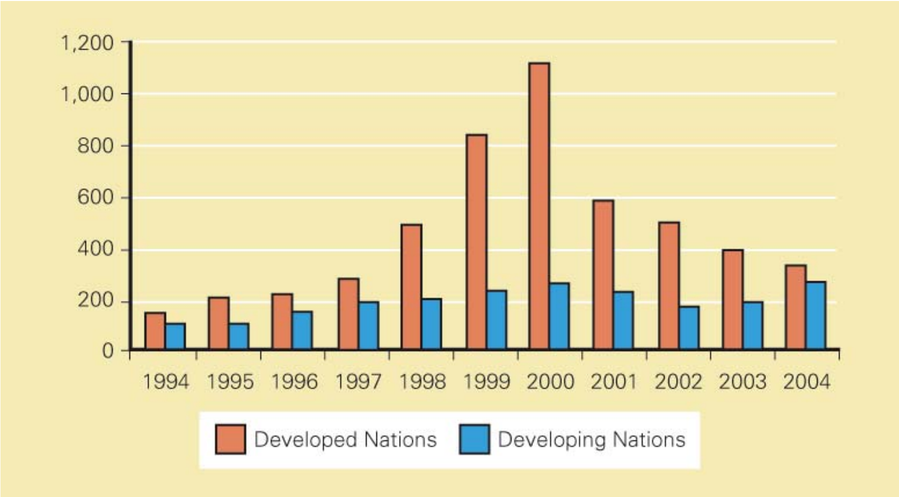


Figure 4

By implication, the volume of the international trade increases in the long-run at an average annual rate of around 6% and indeed quite independently from economic growth. This difference is interpreted to imply that countries attempt to maintain their economic growth by resorting increasingly to international trade. However, at the same time, it should be noted that almost 50% of the international trade is taking place among EU, USA, and Japan, i.e. the so called TRIAD.



Source: UNCTAD database

Figure 5

On the other hand, Figure 5 depicts the amounts of Foreign Direct Investment (FDI) in billion dollars that went into developed and developing areas of the world. Even through after 2000 there took place a significant deceleration, in the last two decades the trend in the flows and stocks of such investments is positive and more so in the developed areas.

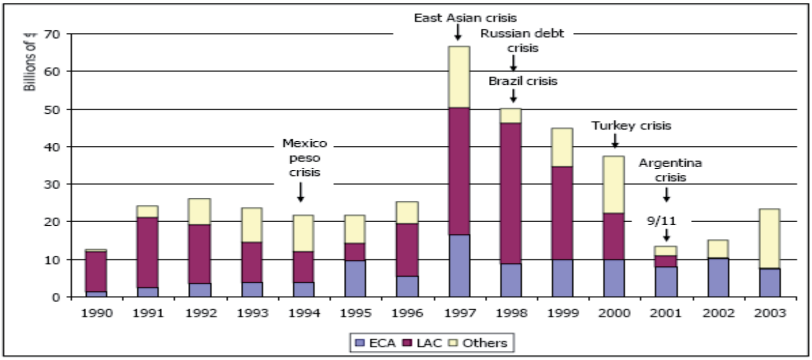
Based on the above it is reasonable to surmise that, as more and more countries come to appreciate the benefits that accompany international trade and foreign direct investment, globalization will accelerate.

6. The rise of global products and global customers

As the ever spreading use of internet, tourism, and other trade relations bring people nearer together, consumer tastes, consumption habits, and product preferences become more and more homogeneous across countries. On the other hand, the capabilities associated with the technologies of just-in-time production, and not only, enable companies to locate and produce anywhere and then ship their products to any location. As a result, in recent decades reaching global customers with the production and marketing of global products has transcended the narrow confines of big multinational companies and spread into medium and smaller size enterprises. This explains why we find now the same products in the stores of nearly every country we visit.

7. Privatization

Privatization is a policy under which governments particularly in developing nations sell or transfer the management of public assets to private concerns for the purpose of accomplishing various objectives. This policy was applied widely from 1970 to 1990 all over the world, then in the 1990s it lost some of its traction, but more recently it seems that it is accelerating again as many countries attempt to become more competitive in the light of the economic crisis. Figure 6, which is based on data from the World Bank, indicates how the index of proceeds from privatizations evolved over the period 1990-2003 in three regions, namely Europe (ECA), Latin America (LAC) and all others. From this we observe that privatization activity in all three regions decelerated significantly after the crises that occurred in the late 1990s and early 2000. But from then on it has picked some speed again.



Source: World Bank Privatization Database

Figure 6

Clearly, this policy fosters globalization in at least two ways. First, by providing opportunities for Foreign Direct Investments, as buying and operating high value public assets in many countries cannot be effected by local investors, and, secondly, because by contributing to competiveness countries are enabled to integrate easier into world markets.

8. New Competitors in world markets

Not long ago the only multinational companies that roamed in the world originated in the developed capitalist countries. Oil, automobile, electronics, chemicals, shipping, food, and other giant corporations were predominantly American or European. However, starting from the 1960, companies based in Japan and the newly emerging countries started to challenge their dominance. Now there is no need for me to mention what happened in most of these industries. With a few exceptions the industrial basis of the world has moved eastwards and now multinational companies like Toyota, Mitsubishi, Toshiba, Samsung Electronics, Taiwan Semiconductor, etc., are leaders in their sectors. This was made possible because globalization allows fierce competition among the best of the best companies and opens new opportunities for companies that we do not know of today, but which will lead in the future. In other words, globalization goes hand in hand with entrepreneurship and the systematic pursue of excellence through Research & Development (R&D) and keeping world markets open to newcomers. This is a most dynamic process which cannot be controlled by any single company or government.

9. The rise of global standards of quality and production

Multinational companies follow a great assortment of strategies to strengthen their position in world markets. Some produce one or a few versions of a given product with specific country differentiations. Others adopt more regional strategies by differentiating their products to better suit the desires of local customers. And still others allow wide limits of adaptation to their local affiliates. In each case the best strategy is selected on a cost–benefit basis because, as it is easy to understand, more varieties of a given product cost more to produce and market. However, the tremendous expansion of such activities was significantly propagated by the establishment of international organizations that imposed standards in the quality of products. Such quality assurance organizations have proliferated in all activities and in all regions. For example, in Europe we have the International Organization for Standardization (ISO) in Geneva, Switzerland - ISO 9000:2000.

10. The internet and information technology

Lastly, I can hardly stress the power with which the diffusion of information through internet and other means of electronic communication have accelerated the speed of globalization. In our days all aspects of control and management of a multinational company are done mostly from the headquarters. Just in time production and delivery, logistics, and the ability to fine tune operations are a few examples of activities that would be utterly impossible to conduct without internet. Moreover, medium and small companies which operate in world markets would be unable to compete with the giant and well–capitalized enterprises.

In summary, owing to these seven forces, globalization may go through phases of acceleration and deceleration, adjusting in accord with the cyclical movements of the world economy, but its trend will continue to point upwards. The fundamental reason for this is the benefits that nations reap by integrating their economies into world markets.

11. An assessment of the criticisms against globalization[3]

The process of globalization did not start either yesterday or a decade ago. It started since unmemorable times when people in one country sent their goods by land or sea to other countries to exchange them with other products they did not produce but wished to have. In other words, globalization started ever since people discovered the truth of the theorem that through voluntary exchange of goods and services material prosperity and quality of life may increase for the average citizens in those countries that take part. Therefore, as I argued already, the forces that promote the opening of economies and societies to international trade and other exchanges are so powerful that no country is strong enough to stop globalization. However, at the same time there is a growing group of well-respected people, including some prominent figures from universi-

[3]The literature which examines the effects of globalization is enormous. For the readers who are interested to find where the discussions stand at the present on the various issues, a representative sample of solid sources, to begin with, would include: Milanovic (2005, 2012) and Hurrel, Woods (2000), on Globalization and Inequality; Goldsmith (1996) and Najam, Runnalls, Halle (2007), on Globalization and the Environment; Tomlinson (1999), on Globalization and Culture; Singer (2004), on Globalization and Ethics; and Giddens (2000), on how globalization reshapes working and living conditions everywhere in the world.

ties, politics, religion and culture, who raise various strong objections. This means that, while initially the criticism originated with people who oppose the system of open economy and society, today the situation is different and we must see whether their criticisms point to problems that need to be addressed. So what I intend to do next is to assess the main arguments they have put forward.

12. Globalization increases inequality and poverty

One of the main arguments used by protesters against globalization is that it increases inequality and poverty, both between countries and within them. Usually in support of their arguments they rely on the calculations that Milanovic (2005) has made using data collected on behalf of the World Bank, covering the period 1988-1993. His calculations showed that the Gini coefficient of income inequality rose from 63.1 in 1988 to 66.9 in 1993, recording a percentage increase of 6%. But can one conclude from this evidence that globalization contributes to inequality in the income distribution, and hence to a worsening of poverty in the world**?** My view is that such a conclusion is not warranted for the following reasons.

To be sure the data on which the above calculations are based are much more detailed and more reliable than any previous study of the likely forces that may contribute to inequality and poverty. However, the period they cover is very small and we cannot know if these findings traced a temporary trend, which reversed in the years that followed, or if it constitutes part of a more permanent trend. Obviously, those who draw on this evidence to claim that globalization is responsible make a jump of logic by assuming that the rise in the Gini coefficient captured a well-established long-term trend.

However, suppose for the moment that they are right and that this finding revealed the existence of a permanent trend. Then the following question comes to mind naturally: Is globalization the sole cause for increasing poverty or are there also other forces, and perhaps more important ones, that feed on this trend? To this question the critics of globalization respond by saying that there are certainly other factors at work. In particular, most commonly they mention that: a) economic growth in rich countries is faster than in poor; b) the population is growing faster in poor countries than in rich; c) for many decades in Africa and in rural areas of China and India there has been economic stagnation, and d) in China and India, the inequality between rural and urban areas is widening. In this light, serious researchers would have thought that there is an identification problem in the sense that one cannot tell how much each of the numerous factors contributes to inequality and poverty. Yet, ignoring this major issue, they go on to claim that for the increasing inequality and poverty the main cause is that: "information technology and liberalization of financial markets is causing a disproportionately rapid increase in the number of very wealthy households without at the same time reducing the number of very poor ones." Therefore, the question transforms into the following: Why might these two forces of globalization work against the poor peoples of the world?

To answer it a straightforward approach is to direct attention to those places where inequality and poverty have increased the most. Apparently, this has happened in Africa and in the rural areas of China and India. Can we consider these regions as victims of information technology and liberalization of financial markets? Since these areas are geographically and economically extremely isolated, the answer is certainly that their poverty has nothing to do with these factors. Hence, the most logical thought is that these areas are victims of their lack of internationalization and the problem they face is how to stop them from being isolated.

How valid is this view is also corroborated by the realization that every poor country that found its way to a more or less decent standard of living in the past century has succeeded thanks to globalization. That is, by producing goods and services for global markets rather than trying to achieve economic self-sufficiency. No one denies that in the process of economic growth in many export industries workers are paid much lower wages than the wages prevailing in developed countries. But to put the blame on globalization for this, one must close his mind to two indisputable facts. First, that these workers were impoverished before the jobs were created by Foreign

Direct Investment and exports, and, second, that poverty in regions geographically and economically isolated is far worse than in those regions which have reached some degree of integration into world markets through globalization.

In short, all available data indicate that economic growth reduces poverty. Also, in many poor countries that have managed to find a path towards economic development, the historical records show that their income per capita showed discernible signs of convergence to that of the rich countries. But many other countries and regions within countries have not been able to take off in economic development. No matter how awful this realization is, the way forward is clear. In particular, the challenge for them is not how to protect from globalization, but how to engage through it in the process of economic development and technological progress.

13. Globalization reduces national sovereignty

The financial crises in some countries of Southeast Asia in 1997-1999, in Turkey more recently, and Greece currently have provided the critics of globalization with opportunities to claim that it allows managers of short-term funds the ability to blackmail the governments of weak countries by inducing the International Monetary Fund (IMF) to impose stiff austerity measures against their people. The reality is that poor countries cannot on the one hand do everything in their power to attract Foreign Direct Investment and on the other to seek protection from the mobility of capital. Nor is it possible for IMF to intervene to save from bankruptcy countries with profligate and wasteful governments, because not only the IMF does not have the required vast resources, but also there a serious moral hazard problem arises. Hence, if some countries lose sovereignty, the blame should not be put on globalization but in the first place on their governments that misused the loans they obtained from abroad, and ultimately on their citizens who voted repeatedly for such governments over the course of many years.

Moreover, contrary to the predictions of the critics that those financial crises would deepen and spread globally, nothing of this sort happened. The crisis in Southeast Asia soon stopped. Turkey returned to very robust economic growth and was able to repay all IMF loans, and my expectation is that a solution will be found in the case of Greece in the context of the European Union.

14. Globalization promotes consumerism

The protesters have a lot of ingenuity. Among those that went to Seattle, for example, to demonstrate against world leaders, we saw people displaying photos of a crossroads in total confusion due to traffic congestion. Others held signs of a national road filled with kilometers of cars waiting patiently to pass through a bridge. Some others mocked the aesthetics of a building with satellite television antennas in every balcony, etc. Obviously the message they wished to send is that these phenomena are indicative of a decaying material culture that has no other goal than to increase consumption.

Now it is true that most people bear with the hassle of traffic congestion for the freedom and pleasures that are associated with the ownership of a car or motorcycle, they prefer work in the office instead of the hard work in the fields, and despite the annoying image of satellite antennas, they are happy to hang them in their balconies. But why are these consumption patterns bad if they are formed in the context of spending their disposable incomes as they chose? The critics of globalization allege that they are bad because they are promoted to poor countries and as a result the latter get stuck in impoverishment and underdevelopment. The linkage they imply is that overconsumption in these countries defeats their need for investment and to some extent the critics have a point. However, I think their analysis is faulty because they fail to allow for the fact that: a) the diffusion of consumption patterns would take place even in the absence of globalization through other contacts among peoples, and b) thanks to the rapid growth in per capita consumption, the average lifespan has increased, the mortality of infants and mothers has decreased, literacy has spread like never before, etc. Therefore, even though consumerism may be accompanied by certain drawbacks in poor countries, it is the key feature of an open economy and society and one should not judge its merits without allowing for all its pros and cons.

15. Globalization leads to depletion of natural resources

Another criticism is based on the view that, as per capita consumption increases with the spread of globalization, the available natural resources will run out soon, so future generations will be condemned to a state of irreversible poverty. Initially this assertion was raised by the Club of Rome and since then many more have repeated it by focusing on particular resources like oil, wood, many foodstuffs, and other commodities.[4]However, their predictions so far have not materialized. Nor is it expected that there will be shortages of natural resources in the future for three reasons. First, because the quantity of resources depends on the inventiveness of human ingenuity and entrepreneurship, which for all conceivable purposes are infinite. Second, because - as we know from the experience in the last 200 years - in the market system inventiveness is endogenously directed to those resources that become relatively scarce and need to be substituted by other resources in relatively abundant supply. And third, the resource content of goods and services moves along a long-run declining trend thanks to technological innovations that are bent on economizing resources by all means. In the light of these processes, one may concede that from time to time there may emerge shortages of certain resources, but the claim that globalizations drives the world to a state of general scarcity of resources is unjustified and undermines the hopes and expectations of poor and developing countries.

[4] See Meadows, Randers, Meadows (2004).

16. Globalization harms the environment

In recent decades technological progress has restricted significantly the adverse effects of production technologies on the environment. But so far there exist no environment neutral technologies for the production of goods and services. In turn this implies that, as globalization spreads and per capita incomes increase, more and more pollutants are emitted in the environment. Hence, the assertion that globalization harms the environment has a basis in facts that are difficult to deny. That is why this argument against globalization has won many supporters. It is simple, it is based on plausible facts, and by raising doubts about the sustainability of human race in this planet it seems logical. But three reasons make it quite contestable. The first of them is that pollution is worst not in the rich but in the poor countries. In other words, pollution in these countries has been the result of the reckless environmental policies of their governments and not of multinational companies that located there, even though some multinationals have behaved badly. The second reason is that by integrating into world markets the governments of globalized countries are subject to the continued supervision of international organizations and as a result they are obliged to follow good environmental policies. Finally, the third reason is that world markets provide countries with considerable flexibility in dealing with the problem of pollution. For example, a country may trade for rights to pollute, which leads to pollution levels considerably lower than those that would result under existing technologies and per capita consumption, if countries operated in complete isolation.

17. Globalization hurts the diversity and cultural heritage of peoples

The protesters argue that in a globalized environment, which will be dominated by international markets, there will be no room for the cultivation and development of those characteristics that make each country unique. Therefore, they conclude, globalization threatens the language, the religion, the traditions, and the culture of various countries with extinction. Is this possible and if so under what conditions?

As I mentioned above, even though the pace of globalization has increased in recent decades, the process has been recorded since immemorial times. In the course of history we know that through it some cultures thrived whereas others disappeared. For example, the Babylonians, the Assyrians and the Phoenicians disappeared along with their cultures. But the Greek, the Roman and many other cultures continue to survive and evolve. Based on this realization the view that globalization threatens the characteristics that give peoples their uniqueness is a speculation of incalculable order. Someone may legitimately argue that because through globalization cultural goods will be opened to international competition, those of a country may "lose market share" even in the preferences of its citizens. This possibility does exist. But what will happen eventually no one can tell because the result depends on the incentives of peoples to support their cultural heritage and promote it as their trade mark in the international community. Personally I think that Greek cultural goods in Europe are of excellent quality and that they enjoy great competitive advantage. Thus, the probability is that globalization will help us "gain share" internationally. But if we doubt about their strength, then we run the risk to fall into the trap of the mechanism that economists call self-fulfilling prophecy. Therefore, the burden of proof that our cultural goods may succumb to globalization lies with all those who support this claim.

18. Conclusions

From the above it turns out that on careful examination all main arguments against globalization vanish. However, this does not mean that the criticisms are completely devoid of benefits. Thanks to the criticisms, we have come to realize that there are side effects that need attention. For example, one is that capital and jobs move from countries with high to countries with low labor costs. This obviously creates unemployment and job insecurity in wealthy countries from where the funds move. So it is reasonable for workers who lose their positions to react. We know also that, while initially globalization caused immigration of unskilled workers, more recently globalization has affected workers with advanced skills.

A second side effect arises from the fact that wages and salaries in the sectors that move abroad are pushed down. This happens for two reasons. First, because workers are forced to seek employment in other sectors with lower wages, and second, because businesses indirectly use the threat of moving to other countries, thus pushing their employees to reduce their wage demands. Thus, in the sectors which are affected unemployment increases and wages decline, thereby worsening inequality.

Finally, a third important side effect is that in the countries where capital and jobs move labor conditions are less than satisfactory. In particular, the hours of work are too long and the conditions of occupational safety and comfort below par. Therefore, despite the improvement that globalization brings to their lives, workers in these countries have many reasons to complain. Although there are effective ways of intervention in the decision making of foreign investors, the protests against globalization have already begun to attract the attention of both governments and international organizations. Early retirement schemes, retraining of workers who lose their jobs, and prolonging unemployment benefits, are some of the initiatives governments adopt and they are in the right direction. But the implied advice of those who object to globalization to return to the era of closed borders and economies is neither reasonable nor justified. The reason is that it will harm the best interests of those poor countries that the objectors purport to shield from the effects of globalization.

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SECTION II

Case Studies

Chapter 4

The Self-Trapped Japanese Economy – An Overview

Toshiaki Hirai

1. Introduction

In the 1990s Japan, as the most successful nation for economic performance, was struck with awe and consternation. While throughout the 1980s the US, UK and the European countries suffered from stagflation, Japan maintained high economic performance. Thus much attention was paid to the clue to the success of the Japanese economy, and the "Industrial Policy" by the MITI (Ministry of International Trade and Industry) and the "Japanese Way of Doing Business" were lionized.

In the late 80s there emerged great cracks in the Socialist Bloc which played its part in the Cold War System. In Eastern Europe the civil rights movement became increasingly active, in its efforts to shake off the yoke of the Soviet Union and introduce some sort of capitalistic system, Poland taking the leading role. The Soviet Union, no longer having the power to crush the movement, finally fell in 1991.

Since then twenty years have passed, and here we are in 2011. During this period the world has gone through great transformation and turbulence. The US achieved some economic growth thanks to the information technology revolution and financial globalization, while the UK enjoyed some growth due to financial globalization. More strikingly, what came as truly unexpected and surprising was the miraculous economic growth of China, India and Brazil, which have come to exert some influence over the world economy.

Japan, on the other hand, was left out in the cold: it tumbled by itself and remained stagnant – hence the so-called “Lost Decade” (or the “Lost Two Decades”).

It became a constant refrain to speak of Japan as the country which could still find no way out of the stagnation, or the one that held a lesson for all. Emblematic was Obama’s statement in the Presidential Inaugural Speech two years ago that he would implement any resolute policy for recovery of the US economy from the crisis, referring to the Lost Decade.

The present paper will look into the realities of the Lost Decade, examining the path along which the Japanese economy proceeded over the three decades.

2. The Misstep from the Supreme Reign

2.1. The Plaza Accord (1985)

In the 1970s the world economy saw the collapse of the Bretton Woods System and the advent of the flexible exchange rate system as a new currency system.

After the yen was fixed at 1 dollar = 308 yen at the Smithsonian Agreement (December 1971), Japan eventually came to adopt a flexible exchange rate system in February 1973. Immediately after that, the yen appreciated to 1 dollar = 260 yen, but remained stable at around 300 yen thereafter. Then a rapid appreciation of the yen occurred as from October 1977, arriving at 175 yen in October 1979.

Besides the change in the monetary system, the world economy also saw US-Japan trade conflict.

The Japanese firms, producing high-quality goods thanks to sophisticated technology, had rapidly expanded sales abroad and come to dominate the world market. In consequence Japan’s balance of trade continued to show a surplus, and so it was that trade conflict arose with the US. As huge exports to the US drove American firms to bankruptcy, the US began to criticize Japan in terms of unfair trade. This US-Japan trade conflict was to continue over the long period, starting with synthetic fiber, followed by steel products, color TV and cars. Japan usually responded to the US with self-imposed restraint. Its balance of trade surplus, however, rapidly increased from 1983 on, and US grievance waxed ever stronger.

At that time the US economy was suffering from stagflation. Volcker, who became the Fed chairperson in August 1979, implemented tight monetary policy ("New Adjustment Finance Method"), causing the FF rate to rise to 20 % ("Volcker Shock"). In consequence, although the price level rapidly stabilized, the unemployment rate rose further, reaching 11%. Due to the high rate of interest, huge amounts of dollars poured into the US, which caused considerable appreciation of the dollar (from 200 yen in October 1981 to 275 yen in October 1983). The exchange rate then settled at around 250 yen, which meant some depreciation of the yen, resulting in a rapid increase in the balance of trade surplus. The balance of trade in relation to the US also showed a huge surplus, which heightened the trade conflict.

It was in these circumstances that the "Plaza Accord" (September 1985) was concluded with strong initiative on the part of the US Administration. This was a pact among the G5 for cooperative intervention in the foreign exchange market. Its aim was, in essence, to appreciate the yen (depreciate the dollar) by selling dollars and buying yen.

In consequence, the exchange rate rose from 1 dollar=255 yen in October 1985 to 150 yen in October 1987. Thereafter the yen went on appreciating until it reached 125 yen in October 1988. Then it went on to depreciate for a while, and again appreciated until it reached 79 yen in April 1995.

In spite of this appreciation, Japan's balance of trade saw a large surplus persisting throughout the 90s.

2.2. The Bubble Period

Speaking of the recent bubble economy we may mention the real estate bubbles of the US, Ireland and Spain in the early 2000s. We can also mention the real estate bubble in Japan, which anticipated them. It continued from December 1986 to February 1991, and its collapse continued from the spring of 1991 to that of 1993.

2.2.1. The Upward Phase (December 1986 - February 1991)

Worries about Depression Induced by Yen Appreciation – As Japan's economic growth had been led by exports, worries spread that the steep yen appreciation due to the Plaza Accord might cause serious depression if the government did nothing. The surplus, in fact, continued to decrease in the balance of trade from 1987 to 1990.

The Nakasone Cabinet then implemented fiscal and monetary policies aiming at stimulating domestic demand. For fiscal policy it put forward the "Emergency Economic Measures" (May 1987) while for monetary policy it lowered the official discount rate to 2.5 % (February 1987 - May 1989). In consequence, public investment as well as private investment increased tremendously. Besides, the nation-wide project to develop the resort area was devised as a means to stimulate domestic demand ("The Resort Act", 1987).

The Japanese exporting firms adopted two methods to tackle the yen appreciation. One was to reduce production cost through a rise in labor productivity. The use of robots in the production process was emblematic of this approach, which amazed the world.

Another method was to transfer production bases abroad for cheaper labor cost. This was extensively carried out, to such a degree that it might have induced) de-industrialization. The ratio of production abroad to total production in the manufacturing sector, in fact, soared from 3.0 % in 1985 to 6.4 % in 1990 (the main location was South Eastern Asia[1]).

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[1] This was a key factor for Southeastern Asia's dramatic economic development thereafter.

And yet Japan's balance of trade showed a healthy surplus, albeit continuously decreasing until 1991. Japan did not see worrisome depression, but maintained the boom thanks to the fiscal and monetary policies.

The Abode of Demons: The Change in the Financial Structure – Under these circumstances, the scene was set for major policy failures – a shift from indirect finance to direct finance (or self-finance) in the Japanese financial structure. As a result of a steep increase in exports, many firms emerged in possession of huge sums of money (the phrase, "Toyota Bank" was emblematic), and felt less need to depend on the banking institution for procurement of capital.

On top of that, the stock market was gaining in popularity, giving rise to a situation that made it easy for firms to procure capital through it. The stock price continued to go up, with the Nikkei Average Stock Price rising from 1,300 yen in 1986 to 38,900 yen in 1989. Around that time a social atmosphere emerged in which more and more housewives caught the bug of investing their money in equities and other financial assets (the so-called "Zai-Tech Boom").

This state of affairs had serious implication for the banks. So far the Japanese economy had continued along a high economic growth rate, and firms were eager to procure a vast amount of capital. As long as the stock market was underdeveloped[2], firms had no means of procuring capital other than borrowing it from the banks. People deposited a large proportion of their increased incomes in the banks (or post-offices), and yet this was not sufficient to meet the demand of the firms. As, moreover, the loan rate was fixed above the deposit rate, the banks were able to finance capital safely by means of rationing.

Then, due to a large-scale shift to direct finance and self-finance, this traditional method no longer served the purpose. In addition, due to the huge surplus in the balance of trade the foreign exchange reserves rose abruptly, which brought the money supply rap-

[2] It should be noted that this was not the case in the prewar period.

idly flowing into the banks. Thus the banks found themselves in a new situation, forced to look for new customers.

Thus the banks came to expand their business, including mortgage loans, stock loans, and free loans (usable for any purpose). Individuals and firms able to obtain loans purchased immobile properties, stocks and other financial assets.

As the property prices and stock prices started to soar, more and more people were eager to get loans, believing that the prices would rise instantaneously. When the prices promptly rose, the demand for loans increased yet further, which in turn drove property prices and stock prices up still further.

Gradually the people making transactions for the sake of pure speculation, carried away by get-rich-quick dreams, came to account for a large weight in the markets. In consequence, eventually the land value within the Yamanote Line reportedly came equal to the land value of the whole of the USA. The objects of the speculatively borrowed money were not confined to properties and stocks, but extended to golf club membership cards, valuable paintings, and even fancy foreign cars. And in fact the prices of these items continued to rocket.

These speculative activities seriously affected the manufacturing industry. Many manufacturing firms came to be devoted to speculation to such a degree that they almost forgot their primary business. There were firms which even boasted larger profits in “Zai-Tech” than profits in the primary business.

The speculative activities extended beyond the domestic to the world market. Speculative investment in properties, stocks, other financial assets, and artworks[3] increased at a faster pace. The purchase of the Rockefeller Center by the Mitsubishi Estate in 1989 was an emblematic case of such dealing.

[3] Successful bidding by Japanese in auctions such as Sotheby’s became all the news.

2.2.2. The Burst (February 1991- March 1993)

As the price of immobile property went up, the unlawful activity in connection with it (i.e. "Jiage") became a major social problem. On top of it, unlawful loans by financial institutions (e.g., counterfeiting of the deposit account by bankers) came to light. Scathing criticisms was then voiced by the mass media and the public on property speculation and the loan stance adopted by the banks.

In response, the Treasury embarked on "the Regulation of the Total Sum concerning the Property Loan" (March 1990). This was an administrative directive designed to hold the rate of growth of the property loan below that of the total loan. In practice it acted as a tremendous pinprick, bursting the bubble.

It was, rather, the stock market which was initially affected. The Nikkei Average Stock Price, which was record-high at 38,000 yen in December 1989, plunged to 15,000 yen in 1992. Then the price of property, which had only seen a decline in the rate of increase even in 1991, dropped sharply. Many firms and individuals engaging in speculative activities were suddenly refused loans by the banks. They were forced to rush to sell their properties and equities, which caused further decline in the price of the stock and the properties. And the bubble burst there.

This, in turn, worsened the balance sheets of the banks and security companies which had made loans to these firms and individuals. It turned out to be difficult to retrieve loaned money, for more and more firms and individuals were pushed into default, and the value of the collateral possessed by the financial institutions plunged. In a word, the loaned money turned into bad debts.

The banks, which initially held the optimistic view that property value as well as the stock price would soon rise, tried to prevent the bad assets from coming to the surface. This they were able to do under the system of acquisition cost basis accounting, unless the bad assets were disposed of. However, this behavior was soon to be denounced by the mass media as "bad asset concealment".

3. Recovery, Stagnation, and Recovery

When the bubble economy turned into depression, what kind of economic measures would the government implement? The phrase, "the Lost Decade" is quite often used to characterize the Japanese economy in this period. However, it is not true to say that all were doomed to failure from the start, for there was a period in which policy was seen to have some effect. It is premature to label it with the blanket term "the Lost Decade". Let us take the period in order.

3.1. Economic Stimulus Measures and Economic Recovery (1993-1996)

While property value and stock price were abruptly deteriorating, the government implemented the following economic stimulus measures, which had fiscal policy to boost effective demand as top priority.

(1) "The Overall Economic Measures" (August 1992. 10.7 trillion yen) by the Miyazawa Cabinet (November 1991 – August 1993).
(2) "On the Promotion of the Overall Economic Measures" (April 1993. 13.2 trillion yen) by the Miyazawa Cabinet.
(3) "Emergent Economic Measures" (September 1993. 6 trillion yen) by the Hosokawa Cabinet (August 1993 – April 1994).
(4) "The Overall Economic Measures" (February 1994. 15.25 trillion yen) by the Hosokawa Cabinet.
(5) "Economic Measures" (September 1995. 14.22 trillion yen) by the Murayama Cabinet (June 1994 – August 1995) together with a lowering of the official discount rate to 0.5 %.

Thanks to these measures, personal consumption and capital investment increased. The Japanese economy was able to accomplish an economic growth rate of 3.1 % in 1995 (as compared with the previous year), and 4.7% in 1996, and fear over the bad debt decreased. Fiscal policy was clearly having effect around this period.

3.2. Fiscal Structural Reform and the Financial Crisis (1996-1998)

Seeing the economically favorable situation, the Hashimoto Cabinet (January 1996 - July 1998) set its primary policy objective on fiscal structural reform. The cabinet raised the consumption tax by 2%, abolished the special tax break (2 trillion yen), and increased the burden on the public through health service reform (2 trillion yen), expecting to increase tax revenue by the total sum of 9 trillion yen.

Contrary to the expectation, however, the economy, which had been showing an upward trend, was to plunge again with this policy. In 1997 the stock price sharply dropped and the bad debt problem came to the surface. At the G10 summit in July 1998, moreover, it was decided that an international bank should maintain 8 % plus as the capital-to-asset ratio (the BIS regulation). The banks concerned carried out extensive credit crunch and credit withdrawal.

Thus the Japanese economy again deteriorated and, additionally, fell prey to financial crisis (the following bankruptcies occurred in succession: the Hokkaido Takushoku Bank and the Yamaichi Security Company [November 1997]; the Long-Term Credit Bank of Japan [October 1998]; the Nippon Credit Bank [December 1998][4]. Asset prices slumped while the number of bankrupt firms and individuals soared, which, in turn, worsened the balance sheet of the financial institutions.[5] The value of the bad debts possessed by the

[4] Ironically, it was in November that the “Fiscal Structural Reform Act” was enacted.

[5] The Housing Loan Companies (“Jusen”) Problem became a hot issue in relation to property. They were subsidiaries for making loans to the property set up by the financial institutions. Even when “the Regulation of the Total Sum concerning the Property Loan” was implemented, money flew, through a loophole, into the Jusen from the financial institutions managed by the Agricultural Cooperation. The Jusen continued to make loans for property. However, this came to aggravate further the balance sheets of these financial institutions under the overall asset deflation.

banks, which amounted to 40 trillion yen in August 1995, jumped to 79 trillion yen in December 1997.

The Hashimoto Cabinet, which faced a serious depression, suspended the fiscal structural reform and implemented the "Overall Economic Measures" (16.7 trillion yen) in April 1998. However, the effect was not favorable. This should not be attributed to the fiscal policy, but rather to the fiscal structural reform, which is, by its very nature, a deflationary policy. The rate of economic growth in 1997 was 0.2 %, and -0.6 % in 1998.

The megabanks, which suffered from a steady decline in asset prices, finally appealed to the government for public funding. In consequence, the following bailouts were made: (i) (February 1998) 18 trillion yen for the 21 large banks including the Long-Term Credit Bank of Japan and the Nippon Credit Bank; (ii) (March 1999) 7.5 trillion yen for the 15 large banks[6] The mass media and public opinion denounced this as a continuation of the so-called "Convoy System".

Through the 90s, spending went to the tune of 18.6 trillion yen for the bankrupt financial institutions, 9.6 trillion yen to buy up the assets from the financial institutions, and 12.3 trillion yen for capital infusion into the almost bankrupt financial institutions[7].

The Line of Financial Liberalization - The collapse of the financial system in the latter half of the 90s constituted for the government a considerable inducement to leave the traditional "Convoy tem"[8]and promote financial liberalization (the "Japan-Version of the Big Bang"). This was carried out mainly by the Hashimoto Cabinet.

The plan was composed of two pillars. One pillar was the liberalization of securities, finance, and insurance.

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[6] The road to public funding for banks was paved by the "Early Promotion of the Financial Function Act" (October 1998).

[7] It is a historical irony that similar things were to be carried out on a larger scale throughout the world after the Lehman Shock.

[8] Another factor is pressure exerted by the US.

In November 1996 the Hashimoto Cabinet put forward an idea for the financial system reform, advocating "the three principles" (Freedom, Fairness and Globalization). The idea was implemented as the "Financial System Reform Act" (June 1998), which advocated: (i) deregulation of brokerage commissions; (ii) promotion of new entry into the banking sector, the security sector, and the insurance sector; (iii) shakedown of the investment trust; (iv) complete lifting of the ban on OTC (Over-the-Counter) derivatives; (v) enhancement of disclosure; (vi) upgrading of the rule of transaction.

This movement was closely tied to the financial liberalization carried out in the US, where the Glass-Steagall Act (1933) was mutilated and eventually taken over by the Gramm-Leach-Briley Act (1999). The US strongly urged Japan to adopt the same approach.

Another pillar was overhaul of the bureaucratic machinery. In June 1998 the Hashimoto Cabinet separated the Bureau of Check and Oversight from the Treasury in accordance with the "policy of separating fiscal matter from monetary matter", and set up the "Financial Supervisory Agency". In July 2000, moreover, the Mori Cabinet founded the "Financial Services Agency", integrating the Financial Supervisory Agency with the Financial Planning Bureau of the Treasury. It is worth stressing that this reorganization brought about a weakening of the Treasury, which had so far flaunted absolute powers.

3.3. Economic Measures and the Economic Recovery (1998 –2000)

The Obuchi Cabinet (1998–2000), which was established in July 1998, when the Japanese economy spiraled downward and the financial system was in crisis, advocated recovery of the economy as top priority: (i) for fiscal policy, the "Emergent Economic Measures" (November 1998. 23.9 trillion yen) and the "Economic Renovation Measures" (November 1999); (ii) for monetary policy, the zero interest rate policy (February 1999). Thanks to these policies the Japanese economy clearly showed some recovery (November 2000).

Then the Bank of Japan lifted the zero interest rate policy (August 2000) although the Obuchi Cabinet opposed it. At that point the so-called "Dot Com Bubble" burst in the US, and the Japanese economy again showed a downward turn due to the decline in exports. The Bank of Japan again implemented the zero interest rate policy (together with the Quantitative Easing policy, March 2001. This was maintained until July 2006).

As compared with the fiscal policy, however, just how much the monetary policy helped in alleviating the economy is doubtful (see Table 3).

According to this table, the monetary base (the account current balance of the banks on the BOJ) showed a big increase in 2001 and 2002, while the rate of increase in money supply (the deposit balance of individuals and firms on the banks) was incredibly low. At that time the credit crunch held sway and the financial institutions were not inclined to make loans to the real economy. Rather, their usual practice was to purchase the national debt with the money obtainable.

(Table 1) Monetary Base and Money Supply (% compared with the Average Balance of the previous year)

	Monetary Base	Money Supply
97	8.2	3.5
98	7.4	3.7
99	9.8	3.2
00	3.8	2.2
01	14.7	3.1
02	21.8	3.2

(Source) BOJ Data

3.4. The Structural Reform and the "Izanami" Boom

It is the Structural Reform and the "Izanami Boom" (February 2002–October 2007) that characterized the Koizumi Cabinet era.

The Structural Reform was an inheritance of the Hashimoto Cabinet as well as representing explicit approval of "Market Fundamentalism" (or the Washington Consensus). The Koizumu Cabinet, which advocated small government and a balanced budget, persisted in a deflationary policy.

The zero interest rate policy by the BOJ attracted US investors who borrowed yen and exchanged them for dollars, which were carried over to the US and used for consumption and investment (the "Yen Carry Trade"). This in turn further boosted the US economy, which had already shown an upward trend. The Yen Carry Trade brought about a depreciation in yen, which induced a rapid increase in exports, due to which the Japanese economy was able to get on a modestly upward curve.

This situation continued from February 2002 to October 2007. Due to its considerable duration it was dubbed the "Izanami Boom", contrasting it with the "Izanagi Boom" (November 1965 – July 1970). However, this boom's beneficiaries were confined to the exporting firms and the financial institutions. At the same time restructuring proceeded in the whole industry; a great deal of labor employment was shifted onto a temporary basis; the level of income remained stagnant, and income disparity widened. Thus the general public had limited awareness of the actuality and benefits of the boom. And economic growth in this period was, in fact, very modest. No wonder it is also dubbed the “Kagerou (or Air Turbulence) Boom”.

3.4.1. The Structural Reform

The Koizumi Cabinet took a critical stance on the counter-cyclical measures and placed major emphasis on the structural reform, for which the Cabinet put forward the following: (i) privatization of the Postal Services, which was the main point of dispute in the general election in September 2005; (ii) privatization of the Highway Public Corporation; (iii) the Structural Special Zone; (iii) the Divine Trinity Reform; (iv) reorganization of the bureaucratic machinery.

It is doubtful, however, to what degree these reforms (some of which were not implemented) effectively contributed to revitalizing the Japanese economy. Many reforms were watered down and privatization was no more than a nominal change. Albeit the bureaucratic machinery was vertiginously overhauled, restructuring of public officials was not touched on at all. Although the Koizumi Cabinet emphasized the private economy (the market economy) and the reduction of activities by the state, the administrative reform dwindled into all bark and no bite.

The structural reform by Mr. Koizumi was carried out with the support of the general public. Although he was a maverick, he had a flair for populism which was unique in the Japanese political scene. When the mass media failed to show interest in a given reform, that structural reform plan came to an end without any substantial change as a result of power struggles behind the scenes. Then another plan for structural reform was put forward to attract the general public.

3.4.2. The "Izanami Boom" (February 2002 – October 2007)

Cavalcade of Deflationary Policy — To repeat, the Koizumi Cabinet took a critical stance on the counter-cyclical measures. It implemented, in fact, a series of deflationary policies as follows: (i) a hike in the consumption tax rate; (ii) the abolition of income tax credit; (iii) an increase in health insurance premium; (iv) extension of retirement age.

They were founded on a microscopic (or microeconomic) idea of normalization (or equilibrium) of each account: (i) in order to solve the budget deficit, a hike in the consumption tax rate, and the abolition of income tax credit were advocated; (ii) in order to deal with the medical insurance fund deficit, an increase in the health insurance premium was advocated; (iii) to tackle the national pension fund deficit, extension of retirement age was advocated.

Of these, the medical insurance issue and the national pension problems are closely related to the aging problem facing Japan, so this is a very serious problem to tackle by any means. However, the reforms were implemented with bad timing. In a situation that saw no improvement for the general public, these measures aggravated their uneasiness about the future, which led to a fall in consumption (rise in the propensity to save).

What was really problematic was the stance the Koizumi Cabinet took on the budget deficit. A rise in the consumption tax rate, the abolition of income tax credit and a reduction of budget expenditure put heavy deflationary pressure on the Japanese economy.[9]

The Izanami Boom —The above account, however, hardly does justice to the effects on the Japanese economy sufficiently in the Koizumi Cabinet period, for the boom dubbed the Izanami continued.

The Izanami Boom was brought about mainly as a side effect of the zero interest rate policy implemented in March 2001 (which

[9] The Structural Reformers have an allergic antagonism to fiscal policy, but they do not perceive that this can put deflationary pressure on the economy.

was maintained until July 2006). This policy gave rise to Yen Carry Trade on a huge scale. The US economy was beginning to recover, mainly in the housing market, from the 9.11 shock. It was American investors who showed an interest in the yen with zero interest rate. Borrowing yen and changing them into dollars in Japan, they used them to buy properties and financial assets in the US.

The Yen Carry Trade led to yen depreciation, so the Japanese exporting firms were able to make huge profits. The contribution ratio of the exports to the economic growth in this period, in fact, reached almost 60%. Due to increased exports, capital investment rapidly increased as well.

And yet, the annual rate of economic growth in terms of GDP was relatively low (2%). This was greatly affected by stagnation in consumption due to a deterioration in labor conditions (including a large-scale shift from normal employment to temporary employment and little or no increase in wages) and widening income disparity. The general public chose a life style to save (not to consume). The sales of the retail trade including the department stores and the supermarkets continued their prolonged decline.

The Izanami Boom was largely dependent on exports, lacking in domestic effective demand. Although the exporting firms and the financial institutions made huge profits, a sort of social uneasiness spread again due to the restructuring, the predominance of temporary employment[10] and little or no rise in wages. To the eyes of the general public who could not enjoyed no benefits, the Izanami Boom was the Kagerou (Air Turbulence) Boom.

3.5. After the Lehman Shock

The Lehman Shock, which broke out in September 2008, caused the collapse of not only the US economy but also the rest of the world economy. Far from being an exception, Japan suffered serious damage.

[10] The phrase "Working Poor" was coined.

Japan, as already noted, experienced the financial system crisis in the latter half of the 90s. During the Izanami Boom, however, the bad debt problem could finally be settled, and the financial institutions made unprecedentedly huge profits. Unlike the US and European financial institutions, the Japanese financial institutes were not involved in the financial bubble associated with securitized papers, for they were preoccupied with the bad debt problem.

The root cause of the deterioration of the Japanese economy was a sharp drop in exports, which was caused by the crisis of the US real economy. Almost all the exporting firms (including the car industry and the electronic industry) racked up huge losses, followed by massive restructuring and stoppage of investment. Consumption, which had long remained stagnant, showed further decline. Thus the Japanese economy abruptly spiraled downward. The stock price sharply dropped as well. Then there broke out speculative buying of yen. As the Japanese government did not intervene in the foreign exchange market, the yen peaked (76 yen) in March 2011.

Facing these critical conditions, however, the Japanese government was too worried about the huge budget deficit to implement counter-cyclical economic measures. Far from it, the bashing of "public investment" became a motto. The main policy of the Democratic Party included Child Benefits, Agricultural Individual Income Compensation, and Free Senior High School Tuition, none of which had anything to do with counter-cyclical measures. The government did not intervene in the foreign exchange market, fearing international reaction. The only counter-cyclical measures implemented were the zero interest rate policy by the BOJ (October 2010; this was the third time) and the Quantity Easing policy. However, even if money finds its way to the financial institutions through the QE (by buying the national debt), the project cannot work well, because of the credit crunch and credit withdrawal by the financial institutions on the one hand, and the feeble credit demand by the firms on the other.

During this period consumption has remained stagnant. Due to a sharp increase in unemployment the general public is uneasy about the cost of living and trying to limit consumption and save money, so we have the saving paradox. In the case of the firms, they are endeavoring to move their factories abroad because of yen appreciation, with the result that de-industrialization is under way. Thus investment remains low as well. Taking the stagnation in exports into account, all in all the aggregate effective demand is very low. Then Japan with its persisting deflationary situation has encountered the apocalypse of March 11, 2011 – the colossal Tsunami and the collapse of the atomic power plants in Fukushima.

4. Looking Back Over the Two Decades

4.1. Japan on the International Scene

Throughout the 80s the US economy suffered from serious stagflation. It was Japan and the West Germany that economically led the world, and Japan was coming into incessant trade conflict with the US. Albeit militarily and politically weak, Japan was outstanding in creating the highest quality manufactured goods through the endeavor of the firms (such as the Quality Control [QC) movement, and innovative technology). Economically speaking, Japan was distinctly top-drawer.

With abundant money supply at its zenith, however, the Japanese economy ran into the bubble, and property prices, stock prices and other asset prices shot up. Failure to tackle the bubble, the Japanese economy was to experience the Lost Decade. Then, helped by the Yen Carry Trade, it was able to maintain the "Izanami (or Kagerou) Boom". Hit by the Lehman Shock, however, it again plunged into bottomless depression. Now severe instability descended both on the firms enjoying high reputation for "Japanese-style Management", and on the laborers and salaried men who were regarded with awe as the "corporate warriors".

The US saw liberalization (above all, financial liberalization) proceed on a large scale in the 80s. In this process the Shadow Banking System (SBS) was enlarged, and the US came to lead the world financially. This, together with the innovative IT industry, boosted the US economy in the 90s. The people went in for consumption while the firms regained self-confidence.

Excessive financial liberalization was, however, to put a great strain on the US economy. The USA had reacted smugly to Japan's Lost Decade, but ironically was now following the same path, to even worse effect, influencing the world economy.

In 1991 the Soviet Union collapsed, and a political situation emerged in which the US took on, also in military terms, overwhelming stature in the world. This, however, did not last long. The US was to be deeply involved in endless conflict in its "War on Terrorism".

In the same period, a phenomenon arose which was to transform both economy and politics in the world. China, Brazil and India, which had long been underdeveloped countries, continued to achieve surprisingly high economic growth. China, for instance, went on growing at an average of 8 % plus over the three decades, as a result of which it became No. 2 in terms of GDP, and No. 1 in terms of foreign currency reserves (2 trillion dollars).

Thus the economic and political structure of the world dramatically changed to such a degree that nobody had been able to foresee twenty years before. Today the presence of the Japanese economy in the world economy is manifestly in decline. While the Japanese economy remained stagnant, the US and the UK led the world in the financial area, and the BRICS and the Southeastern Asian countries raised their position in the area of the real economy.

Twenty years ago it was said that Tokyo was soon to become the world financial center together with New York and London. Now it's a dim memory. Then the Japanese manufacturing industry was proud of its overwhelming productive efficiency, thanks to the introduction of robots. Now it is lagging behind US industry in the IT area. It is, moreover, feeling Korean and Chinese firms at its heels. On top of this, while Korea and China built up a strong backup system through their governments, the Japanese firms evidently lack such support.

The deterioration of the Japanese political system in recent years, and its weak position in the world politics are all too evident.

We can say, ironically enough, that there is no country like Japan for respect of the principle of laissez-faire. While the US, the UK, China and Russia move on the basis of their “national interests”, only Japan seems to leave everything to market fundamentalism. Restructuring of the Japanese political system is indispensable for the resurgence of Japan’s position in the world economy.

4.2. The Main Cause of the Lost Decade

There is an argument that the root cause of the Lost Decade should be seen in the line of cooperation with the US, starting with the Plaza Accord. The real responsibility, however, should be sought in the government’s failure to adjust policies to the changed conditions.

The appreciation of the yen rapidly ran its course in accordance with the Plaza Accord. Soon worries were spreading about the onset of depression. Then the government implemented an easy money policy (the low interest rate policy) and fiscal policy which included public works. Thanks to these measures, the Japanese economy, far from falling into depression, was able to maintain an upward trend. So far, so good.

During the same period there was a great shift in the financial structure, from indirect to direct finance (and self-finance). Due to failure to adjust to this change, the Japanese economy boiled up to the bubble phase. Above all, without implementing tight monetary policy the government allowed the bubble to run its course.

A series of drastic decisions was then implemented tightening monetary policy, such as “the Regulation of the Total Sum concerning the Property Loan”, in order to arrest this process. But the government allowed the deflationary process to proceed so long that the economy plunged into depression (The government should have lifted its tight money policy earlier). Thus a series of asset deflation processes followed, starting with a sharp decline in the price of property and stock prices. Then the Japanese economy saw the collapse of the financial system. It seemed self-trapped through the inappropriate timing of economic policy.

These policy failures were further aggravated by the Structural Reformers' inconsistent policy. They argued that the economy should be left to the workings of the market as much as possible, and should be made efficient through de-regulation. So far, so good. However, they had lost sight of macroeconomic policy so there was no scope for a rational economic policy[11]. The refusal to apply fiscal policy (abnormal reaction to public works) and the implementation of de facto of deflationary policies in the deflationary phase are emblematic examples .

4.3. Chaos and Lost Confidence

Turning to the domestic side, the Japanese people as a whole seemed to shift from impatience into loss of confidence.

In the 90s Japan saw political whirlwinds. In addition, in recent years governments changed within a short period. The Democratic Party, which assembled the cabinet in October 2009, did not implement any policy measures to tackle the economic crisis that hit Japan immediately after the Lehman Shock. The main measures (the above-mentioned Child Benefit, Agricultural Individual Income Compensation, and Free Tuition for Senior High School) did not aim at tackling the economic crisis. The Democratic Party's governments have had no definite policy vision of how to manage the economy, consequently leaving it to the working of the market economy. Fiscal policy is regarded as a sort of taboo, while monetary policy (zero interest rate) has no effect in terms of recovery of the stagnant economy. The government seldom intervenes in the foreign exchange market, allowing the yen to appreciate abruptly (to dollar). In these respects the Japanese government is in sharp contrast with foreign governments (such as those of China, the US, Russia, and the EU) which set out to defend their national interests.

Consequently, even in the international economy theater Japan's presence has dwindled. The State of the Union Address by President Obama in February 2011 was emblematic, for he very often referred to Korea and China without mentioning Japan. In the sphere of foreign policy, the presence of Japan was meaningless. In the redeployment problem of the US military base in Okinawa, and the conflict of the Senkaku Islands, the government voluntarily abandoned responsibility, almost losing its raison d'être.

The firms – the driving forces of the Japanese economy - need to survive on their own in the world market, given the incompetence of the government. Japanese firms continue to be exposed to severe competition from the Korean and Chinese firms. Given the persistent shrinkage of the domestic market, they are forced to resort desperately to some global strategy. What is worrisome, as a consequence of many firms in the industries shifting their factories overseas, is the acceleration in de-industrialization.

The Japanese people seem to be losing self-confidence. Having suffered from restructuring and a rapid increase in temporary employment during the long depression, they are, psychologically and economically, in the throes of unstable conditions. Thus even if the income from savings is almost nil, they have got accustomed to abstaining from consumption.

Reflecting this social atmosphere, the young tend to be introversive. They like a quiet life, avoiding competition and showing interest no in foreign countries. Yet there is no room for this introversive attitude in today's world. Even the Japanese firms which are trying to achieve survival through global operations have a tendency not to employ more young Japanese.

Thus the Japanese economy is in a state of self-trap, finding no exit.

5. Conclusion – New Social Philosophy Required

The Japanese economy is a market economy. Yet market (or private) economy at present lacks the ability to pull itself up by the bootstraps. Even if there are innovative entrepreneurs, the present financial institutions lack the ability and will to provide themselves with the required capital. In Japan, unlike the US, venture capital market has not successfully arisen.

Moreover, the direct finance of enterprises is completely blocked because of the stagnant stock market. The key to boost the market economy should be to form a government capable of implementing shrewd and bold policies. After the private economy had been allowed to bubble, we saw it remaining stagnant. And then the government failed to come up with the necessary macroeconomic measures[11]. This should not be repeated.

"The power of the private sector, the self-adjusting mechanism of the market, economic behavior based on self-responsibility" etc.: these mottos seem to lose color in the present Japanese economy. Entrepreneurs are not necessarily beings that can be completely entrusted with the future of the Japanese economy. What they are doing at present is to reduce costs through restructuring. Although the firms might, by this means, improve the financial conditions to some degree, mass unemployment is emerging in return. It has become common practice for firms to reduce bonuses and lower wages, bringing further deflationary pressure to bear on the economy.

We suggest that both efficiency, by means of the market, and security, guaranteed by the government, should be required for the smooth working of the market economy. It is important for the economic agents to feel some degree of stability. It is an obligation for the government to work out the institutional framework, because only within a stable framework can the people engage in competition with self-confidence. Contrastingly, a society in which people are subject to uneasiness, seeing no future prospects, and dropping out as a result of competition, is not a good society. "Self-responsibility" has no meaning unless some degree of stability and safety is guaranteed. A jungle of business competition à la Hobbes is to be avoided.

[11] This is a responsibility of macroeconomics as well.

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Chapter 5

Indian Economy and Society: Globalization and Economic Reforms[1]

Sunanda Sen

1. Markets in Economic Theory and Policy

Markets today remain integral to the politics and economics of mainstream neo-liberal doctrines. Policy prescriptions as follow from dominant official circles often share an uncritical acceptance of such positions, thus attaching a great deal of importance to the expansive path of the market. Views as above treat the market as a major institution which holds the key to a path of maximum growth with efficiency, by enabling producers, consumers as well as the labourers to operate and exercise options according to their rational choice. Based on the foundations of methodological individualism, an exercise of free will as above is also consistent with the much celebrated optimality principle formulated by Wilfred Pareto back in the 1920s. The doctrine is considered to provide a unifying link between the markets for final output and those for labour and capital, the latter with inputs rewarded according to their individual contribution in the production process.

[1] An earlier version of this paper was presented at the Plenary Session of the Italian Association of Political Economy, Rome 2008.

A free market as viewed above in neo-liberal economic doctrines is supposed to provide opportunities for an economy to maximise, at a point of time, potential output and its utility from consumption, while providing the best possible returns to capital along with the best available wages for labour.

With disproportionate power as is usually enjoyed by the advanced nations in material terms and with their geo-political significance, advocacy for the opening and liberalisation of markets has continued to prevail, both on the official view of the advanced nations and on positions taken by the international financial and trading institutions, dominated by the same set of countries. As for other nations, which include the developing, the least developed and the transition economies, these have been at the receiving end, with their policy makers either too ready or obliged to adopt and put to practice the market-oriented policy prescriptions. Moves to launch market-oriented reforms reflect the desire to remedy what is seen as the so-called inadequacies/imperfections of markets in these economies, which are also held as responsible for their lack of development!

Viewed from an orthodox Marxist perspective, the market as an institution can be seen as necessary to promote the expansion of capitalist production processes. Thus capitalism accumulation is made possible as the free market enables production to be based on wage labour, commodity production and exchange[2]. From this angle advances of the market are treated as a necessary pre-requisite of a capitalist expansionary process. It provides a run up to transformations by compulsions, on the part of capital, to improve productivity and to extract surplus (labour) value by employing labour who works at low wages (equivalent to necessary labour) for survival.

Some debates within the Marxist circle, on the historic and institutional specificities of capitalism (as a form of production, exchange and distribution), also connect the role of markets to capitalism. For the school led by Immanuel Wallerstein and Gunder Frank,

[2] Dobb (1946).

markets have remained central in bringing about a world system of trade and exchange, as happened since a period as early as the 16th century. The process, according to them, also heralded the advent of capitalism[3].

For other scholars, like Maurice Dobb, trade, exchange and markets, *while necessary, are not sufficient* to warrant a path of capitalist expansion. Thus trade can be there even with serfdom or its variations, which limit accumulation and the expansionary effects of the market. As pointed out, in absence of wage labour, commodity production for exchange and the ability of capitalists to accumulate by using surpluses from wage labour, it is not possible to have an expanded reproduction which makes for capitalism[4].

However, positions as above, while relevant in the context of the accumulation process under advanced capitalism, cannot be applied to the developing or the least developed countries, where production and exchange have continued to dwell on several non-market relations. For mainstream economists markets here are other than perfect or fully functioning, a factor responsible for their backwardness. The call for liberalisation and opening of markets thus follows as a logical cure-all for low growth and underdevelopment[5].

It may be relevant here to point out that, to understand the dynamics of capitalist accumulation in market economies, one has to go beyond the standard tools of economics. As it can be found in the classic work of Karl Polanyi, there exist, in all societies, a set of protective as well as countervailing forces which regenerate and sustain the 'mutually supportive relations' in society. As capitalist expansion enlarges the sphere of the market, the latter tends to subordinate the society and to destroy the social fabric through the imports of standardized capitalist values, body and soul as embedded in the culture of the global market. This is done by the violation of both the basic human nature as well as such requirements of indigenous people as are

[3] Wallerstein 1974, see also Sweezy 1950 pp. 134-57.
[4] Dobb, 1946, in Jomo and Reinhart 2005.
[5] See, for a short account, Sen 2007.

fundamental and intertwined with family, community and social relations. In terms of this position, unlimited expansions of the capitalist system along with the market, while generating fast growth of output and accumulation, are capable of causing "dispossession, displacement and human degradation"[6].

Markets (with their adjunct, which is capitalism), in the alternate view as above, are sustainable only when "embedded" in society. This is partially achievable with attempts on part of institutions, including the state, to act in a manner which conforms to the preferences of the society. It is usually done by regulating and stabilising the market economy to achieve some degree of political legitimisation.

Markets, as described above, have come up in a large number of countries today, often carrying the label of "Emerging economies". For the majority of these countries, and in particular for the developing countries, the expanding market most often remain "dis-embedded" from society. Often the process generates reactions from what is known as civil society, which also can take the form of political struggles/resistances. This has the general pattern which takes the form of social and political protest movements. Reactions as above, while impairing the pace of market orientation of the society, also help the market itself by bringing up to the surface what all are acceptable to members of the society. Described by Polanyi as a "double movement"[7], the process is one which is but expected in a functioning democracy.

There remain, however, considerable discrepancies between what all are sought after in terms of the social and political movements within a country and the realm of what are achievable. The mediating role provided by the state here assumes a great degree of significance in these liberal market economies, where the state is subject to an "existentialist contradiction" between unfettered competition and expansion of capitalism on the one hand and the political necessity of sustaining a minimal façade of a mutually

[6] Levitt in Jomo 2005

[7] Ibid. see also Polyani 1944.

supportive and self-reinforcing society on the other. Rejecting this position, the neo-liberal mainstream view continues to treat the market as the sole arbiter, using the narrow economism of supply and demand. It thus ignores the role of social institutions which shape up the civil society, the social and political movements in such societies and the responses which the latter is capable of eliciting, from the state, the community and other voluntary groups.

2. Markets, State and Society in India

India, since her independence from the British rule in 1947, has witnessed, between 1950s and 1990s, a rapid transformation of the economy from state-led industrialisation to *laissez faire*. Following the theoretical frame of Karl Polanyi in his classic book titled *"The Great Transformation"*, one observes the following four sequences of what Polanyi described as the 'double movement' in market economies:

1. economic reforms and liberalization;
2. impact on economy with regressive consequences;
3. resistance from people-centred organisation, the society;
4. redressals from state with limited measures.

We would touch upon the above four issues in our analysis of the Indian economy in the subsequent part of this paper.

3. The Transformation

Problems as arise with steady expansions of the market are amply demonstrated in the rapid transformations of the economy and society which India has gone through, especially, in moving away from state-initiated partial planning and industrialisation during the first two to three decades of the country's independence to full scale economic reforms in 1991. To dwell on these changes, we need to pay attention to the early pattern in India of a developmental state and its transformation with the market at the centre-stage.

We document, in the following pages, the four elements of the 'double movement' in India, as spelt out above. These deal with state policies (intervention/liberalisation), the related state of the economy and society, movements from civil society and political groups and finally, the responses from the state as arise in way of remedial measures.

Early years of industrialisation followed by gradual erosion of state authority and steady advances of the market.

Policy makers in independent India led by the Congress party initially stood for a path of industrialisation in terms of a closed economy model. Following the pattern of Soviet industrialisation it relied on an import-substituting industrialisation strategy, using heavy industries, large public sector, licensing and controls over trade, industry as well as external payments and an emphasis on development of science and technology. By the mid-sixties the initial growth spurts were followed by economic stagnation. Faced by a balance of payments crisis , external pressures, especially from the World Bank and the United States, led the country go through a steep currency depreciation and deflation with cuts in capital expenditure. Fuelled by cuts in private investment, there resulted an industrial stagnation, intermittent agrarian crisis, rising food prices, agrarian protests, intensified labour unrest and mass movements, all at an unprecedented level in independent India.

Resentments and protests were voiced by opposition political parties as well as by the general public, and matched by armed resistance movements in the countryside of Eastern India (Naxalbari) demanding land reform. Largely in response to above, the state launched a 10-point programme of regulation which included nationalisation of banks and the insurance sector, state trading, controls over monopolistic practices, abolitions of the managing agency system and privy purses in princely states, introduction of public distribution in food grains and some measures of land redistribution. In the coming years exchange control in the external sector was consolidated with the Foreign Exchange Regulation Act (FERA) to prevent leakages of foreign exchange and money laundering. A brief period of a regime with alternate policies followed, with a populist pro-poor agenda to help small industry, decentralised administration, food subsidy and employment schemes which provided options for 'Food For Work'. However, the trend was to be reversed soon as authorities who came back to power shared an agenda endorsed by the conditional loan package from the IMF in 1981, directing a right-ward shift in official policies. Strict limits were imposed on fiscal deficits as a proportion of the GDP and within a few years several de-regulatory measures followed, relating to trade, technology and finance.

Some limited employment programme and some measures to improve health, education and the status of women in the economy also followed. However, policies towards liberalisation continued in full steam with the successive regimes which came to power subsequently, each bent on following a market-oriented neo-liberal policy.

India formally launches economic reforms in 1991.

Economic reform was the main agenda of the Congress party which again came to power in 1991. Depleted official reserves, large deficits in balance of payments, and sharp declines in GDP growth (which was reflected in similar declines in almost all sectors of the economy), demanded urgent attention. For those in power, economic reforms were considered as the panacea and a cure-all to combat the economic crisis as had engulfed the country. Those changes in economic policies targeted the prevailing controls and regulations as still existed in the economy, relating to trade, technology, finance and even labour.

Looking back, the year 1991 can be treated as the turning point in economic policies, with the launch of wide-ranging measures to de-regulate the economy. Those were to continue and gain momentum in the coming years, despite short-lived changes in regimes.

By mid 1990s there was an implicit consensus or unanimity among political parties in India regarding the need to continue with the reform process as an irreversible path or TINA (There is No Alternative) syndrome. The deviations, at level of state governments run by left-wing parties, were no exceptions when it concerned the major decisions. As mentioned above, these policies were backed by the neo-liberal doctrines of growth via efficient market which by this time was already an accepted mainstream position.

We deal in the next few pages with the major changes in policy as have taken place since the onset of the major reform drive in 1991, in specific areas of trade, technology, finance and labour.

4. Liberalised trade and technology

The steady opening up of the domestic market with liberalisation of trade which started in mid eighties geared up its momentum in the following years. This came with the scrapping of quota licensing and with steep reductions in import duties both of which were in compliance to the WTO norms. This led to subsequent increases in import intensity of output. As it can be expected the measures also led to changes in the composition of output and the pattern of technology as used in industry. With new products catering to the domestic market with demand by the middle class and the rich, the upgraded technology, now availed of by industry from the global market to gain a competitive edge, production required less labour and more capital and skill.

As one can expect, proportion of imports to GDP at current prices had moved up significantly, from 8.3% in 1990-91 to 22.06% in 20011-12. It is worth recalling here that a rise in imports as a proportion of output, while providing requisite inputs to investment as well as consumption with the new import-intensive technology, dampens simultaneously the demand for domestic output by an equivalent amount. Moreover the displacing of the import-substituting industries by those which are import intensive can, in extreme cases, be a cause for what we have labelled elsewhere as an 'import-led GDP compression'[8].

[8] Sunanda Sen, "Import Liberalisation as a Tool of Economic Policy since mid-Eighties", Economic and Political Weekly, 27(12), 1992 (also in Idem, Trade and Dependence. Essays on the Indian Economy, Delhi: Sage India, 2000).

The above process of import liberalisation, which started off with the conditional loan package from the IMF in early 1980s gathered momentum, with compulsions, in terms of the WTO negotiations, to abide by the tariff cuts and the scrapping of quantitative import controls. This had several implications, with some having serious consequences for agriculture; especially with the entry of subsidised agricultural products from the advanced countries. The latter made it difficult for local production units to compete in the domestic market. For industry the shift in the pattern and technology of output has made it difficult for local units to access the newly opened up opportunities of import-intensive and high-tech pattern of production in the arena of global markets. In the process some of the major industries including cotton and jute textiles, light engineering industry went through a process of decay, and to that extent a process of de-industrialisation.

Import liberalisation also had an impact on technology inflows to the country which were linked with the WTO initiative for Trade Related Intellectual Property Rights (TRIPs). In India advances in R&D for science and technology as had taken place over the earlier decades can be viewed as a fall out of the national patent regime, granting patent rights only to process technology which ruled in India and other developing countries for in-house innovations with indigenous technology by local producers. As it is held by the neo-liberal school, technology is a free public good which, if markets are free, would be accessible to all countries and all individuals within, thus conforming to the notion that the world is flat[9]. Policies as logically follow are for opening up the technology frontier, and to build and expand the 'knowledge economy', across and within nations.

In India the software industry of the Information Technology (IT) sector has witnessed a phenomenal expansion in recent years, which is largely a fall-out of both the initial advantage in terms of skill-formation (which started during the early years of industrialisation) and the man-power to access advanced technology. Both have provided incentives to foreign capital in the IT sector. However, de-

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[9] Friedman, 2005.

spite the success of the IT industries to compete in the world market and to create a hub for jobs as well as to provide newer facilities for communication in the country, and an ability to provide additional sources of exchange earnings, the functioning of the market has failed to narrow down the gap between those who can access the new-found prosperity and benefits and those who cannot. In effect the expanding market for software revolution in India has created a 'Digital Divide', with a large number of the poor in the wrong side of it. Furthermore, the future prospects of the IT sector entirely depend on the global economic conditions. This is reflected in the recent sub-prime crisis and recession in USA which led many global and local IT companies shred off their strength.

Advances in technology and facilities for its open access have encouraged capital from overseas to enter India. Thus FDI (Foreign Direct Investment) inflows have shot up from \$113mn in 1990-91 to \$37.74bn in 2009-10. While the current inflows of FDI do not compare with the spectacular inflows to China, India still stands out as a major destination among the Emerging Economies[10]. Relaxation of the prevailing controls on flows of external finance as well as fiscal incentives along with labour market reforms provided further incentives for foreign capital, which was keen to enter and make use of the expanding domestic market in India.

[10] However, there are some anomalies between FDI definitions as used in China and India. Attempt was made in 2002 to correct these anomalies by changing the FDI definition in India as per IMF norms to include reinvested earning and inter-corporate borrowings. As a result the gap between FDI inflows in India and China was little narrowed down since then. However, still some gap exists in accounting practices as imports of capital goods used in Foreign Enterprises are treated as FDI in China which is not the case in India.

5. Financial Reforms

Reforms in India encompassed several aspects of the economy in the realm of finance. Initiated in 1981 as a part of the IMF-package of financial liberalisation, official policies in India have continued to follow policies with a drive to lower fiscal deficits, monetarist measures to combat inflation with occasional tightening of credit, banking reforms in the interest of financial stability (thus limiting access to credit for the productive segments as well as the poor) and finally, a steady pace of liberalisation of the external financial sector.

Fiscal discipline, initiated in the country during the early 1980s, has gathered momentum over years. Following the Fund-Bank position relating to the stabilisation package, a ceiling now is binding on fiscal deficit in terms of the Fiscal Reforms and Budget Management Act (FRBMA) of 2003. Successive cuts in fiscal deficit as a proportion to GDP has reduced it from 6.2% in 2001-02 to 4.8% in 2010-11 (and dipping even lower during the next year according to budget estimates). Cuts in the primary deficit have continued to be even lower, at -0.9% in 2007-08 and 1.8% in 2010-11. In terms of budgetary classification the primary deficit equals the fiscal deficit less interest payments. Thus it covers the gap between expenditure on defence, capital expenditure and subsidies over tax and non-tax revenue. With expenditure on defence remaining steady at around 1.2% or 1.3% as a proportion of GDP, the axe naturally comes on major subsidies (for food, fertilizers and petroleum) as well as capital expenditure by the government, with the two actually dropping respectively from 1.7% in 2002-03 and 3.0% in 2003-04 to 1.6% and 2.2% of GDP in 2010-11. The gap between the fiscal deficit and the primary deficit as proportion to GDP kept widening over time, reflecting the rising interest payments on the marketised borrowings by the state, an item which was an inflexible component of the budget. As already mentioned above, fiscal discipline has made it obligatory on the part of the government to meet the expenditure (as remained uncovered from other sources) by borrowing from the market instead of from the Central Bank (Reserve Bank of India) as had been the practice earlier. These marketised borrowings against government guaranteed securities turned out as lucrative for risk-averse investors which included financial institutions who readily purchased those government bonds.

One can here mention other measures to reform the financial sector. Those included the strict credit-risk norms to conform with the Bank of Settlement (BIS) norms of the Capital Adequacy Ratio (CAR) and the Credit Risk Adjusted Ratio (CRAR). While measures as above improved the quality of bank portfolio by reducing the ratio of their Non-performing Assets (NPAs) to total assets , the new rules created hurdles for the poor borrowers as well as the small and medium industry who became the victims of financial exclusion. One notices a sharp decline in the flow of credit to poor and the SMEs whose share of credit from Public Sector Banks and private banks respectively fell from 17% to 10% and from 20.6% to 7.1% between 1999-2000 and 2003-04[11]. Reforms in the area of finance has also de-regulated the interest structure and banks today can fix interest rates on both deposits and advances according to what they consider as profitable in terms of the state of the capital market. While norms for priority sector lending by the Scheduled Commercial Banks has remained at 40% of net bank credit since banks were nationalised in 1979, the practice is now subject to the anomaly that no targets are set for lending to the small sector industry (SSI). With advances to agriculture and to weaker sections within the priority sector set respectively at 18% and 10% of NBC, SSIs are effectively left with no more than 12% of NBC as a residual. In addition one can observe tendencies, even in terms of priority credit, to introduce new items as priority credit, as consumer loans, housing credit etc., which openly flout the social norms of the credit policy, as it used to be earlier.

The steady process of capital account opening in the country includes the free entry of Foreign Institutional Investors(FIIs) to the country's stock markets and large number of concessions offered to FDIs. These facts have created profit opportunities, both for foreign direct investments and for portfolio capital through speculation and

[11] Sunanda Sen and Soumya Kanti Ghosh, 2005.

arbitrage. The late inflows of portfolio capital have far exceeded those of FDIs , creating an atmosphere of speculation-led high finance in the economy. Thus net inflows of FDI were at $ 9.3bn as compared to net inflows of portfolio at $30.2bn in 2010-11. Unlike what could be achieved in the real economy by Initial Primary Offers (IPOs) of equities with FDI inflows in the primary market of stocks, short-term portfolio investments, which cater to the secondary markets of stocks, are incapable of generating fresh investment demand, at least in the first round. Instead these flows create fresh opportunities for profits on speculation by generating uncertainty and volatility in the stock markets and push up the returns on financial assets to levels much higher than those on industrial securities. Higher returns on financial securities as compared to those on securities held with the industrial sector have prompted corporates and banks to hold a large part of their assets as financial securities. One can confirm the current tendencies in the corporate sector of India to switch their portfolio in favour of financial assets. Investment of these firms in industrial securities has actually fallen from 43% to 34% of their total investments between 2002-03 and 2004-05[12]. The pattern tallies with the asset-liability structure of these units, with "quick assets" covering more than half of total liabilities for the large firms having a sales value over Rs (rupias) 1000 crores (equivalent to Rs 10 billion) during 2004-05. The pattern was roughly of the same order for firms with lower sales values. Financial liberalisation has thus opened up profit opportunities in the financial sector, which in effect is mopping up a considerable part of the re-investible surpluses in the industrial sector. Interest shown by corporates and banks to invest in the high yield financial assets are found to have an added impetus with the on-going employees' stock option (ESOP) system. It encourages the company managers to invest more in financial assets, not only in the interest of the corporate they are engaged in but also

[12] Source: Prowess India on line data. Cited in my article "De-regulated Finance: Some Concerns for India's Industry and Labour", in Philip Arestis and Luiz de Paula (ed) Global Finance and Emerging Economies, London, Palgrave-Macmillan, 2008.

from the pure self-interest of an enhancement in their personal wealth. Use of ESOPs in the IT companies in US has been followed by the use of the device in the Indian IT subsidiaries and elsewhere, as a device to attract and retain the skilled employees. In effect little of those short term investments as well as the re-investible earnings on such assets with finance companies can be directed to pockets of real growth in the economy, since major parts of such assets are deployed to fetch higher returns on speculative finance. It is much easier to speculate in the stock market today with trade in derivatives having a major role. According to the latest estimates, derivative trade has been several times the value of spot transactions, during recent years. As for the average size of the deals, those in derivatives have been more than 25 times an average deal in the spot market[13]. Much of the zeal in the derivative trading is due to the uncertainty relating to stock prices which in India are connected to similar forces in both the domestic and the international market.

As for the impact of FII inflows to the market, in 2006 the FIIs transacted business amounting Rs 2855 thousand crores which is as much as 37% of the country's GDP! FII transactions (mostly in derivative markets which are for speculation) are 6.5 times the primary market transactions (which create equivalent physical assets). It is not difficult to draw the conclusion that financial reforms in India have neither been for growth in terms of the creation of physical assets nor for a fair distribution of the financial flows which are not only equitable but also productive. Instead the country has provided opportunities for speculation in financial assets in a manner as had never been witnessed before. This has considerably been facilitated by the new communication technology, with investors having the facilities to manage their portfolios at the press of a button!

Financial liberalisation, with uncontrolled flows of short term finance from overseas and the rising levels of FDI inflows, have impacted the autonomy of monetary policy on the part of the authorities. As pointed out in the literature, an open capital account (which in India is nearly complete but for resident outflows) and a managed

[13] Government of India, Economic Survey 2010-11, New Delhi 2011.

exchange rate leaves little leeway for autonomy in monetary policy. Pressures to manage the exchange rate within an acceptable band, to ensure both external competitiveness for goods produced within the country and to sustain the net flow of foreign investment from abroad, often give a dual signal to policy makers. Thus an appreciated local currency while continuing to attract foreign investors, may be a disaster for local exporters making it obligatory for the central bank to mediate and tone down the currency appreciation by buying up foreign currency from the market. Additions to official reserve of foreign currency, contributing to high powered money, can, in absence of sterilising actions by the monetary authorities, push up the supply of money. It thus becomes one more responsibility for the central bank to control money supply, by raising the domestic rate of interest and or, as the RBI(Reserve Bank of India) had been doing, by selling bonds to the public as well as by raising the CRR (cash reserve ratio) ratios. Monetary policy, no longer determined by the domestic requirements thus ceases to be autonomous. This reflects the trilemma faced with open capital markets, managed exchange rates and achieving autonomy in monetary policy. We have mentioned earlier the further problems in terms of the fiscal burden of the interest cost on the state.

6. Reforms relating to labour

Economic liberalisation in India has also impacted the status of labour in the economy, especially with the introduction of 'flexibility' in terms of labour market reforms for achieving competitiveness and efficiency. By freeing labour from formal employment under the prevailing labour legislations, labor flexibility was supposed to provide incentives to capital inflows from overseas, with assured labour market flexibility within the country. It has often been claimed that labour in the process can not only be more productive but also would get back the much needed freedom (option) over her/his own "time". The approach, originating from methodological individualism which provides the theoretical background for achieving complete laissez-faire, has been used in mainstream economics to justify unemployment in advanced countries with notions such as the Non Accelerating Inflation Rate of Unemployment (NAIRU).

The scrapping of labour laws in terms of labour market flexibility in India permits “hire and fire” policies, not only for the units in the private sector but also in the EPZ (export processing zones) units in different parts of the country which were privileged to operate without following the laws of the land. Pressures to dismantle the existing labour laws, even for the organised sector where they were relatively protected, often were devised to encourage larger inflows of FDI and to meet the compulsions for cost-cutting faced by industry, both local and foreign controlled. The need for the latter was for achieving global competitiveness by using cuts in the wage bill. The official position on the matter was made explicit in the National Commission on Labour Report which came out in 2002. It recommended , in no uncertain terms, the use of contract labour in view of the uncertain demand from global markets. Also, the move for privatisation of industries, which was often used by the government to raise resources in the name of gaining efficiency in those units, has given a push to labour flexibility. Use of casual labour today has been common in units as are owned by foreign as well as local capital[14].

7. The failed performance of reforms and remedial gestures by the state

Economic reforms, operational in full swing since 1991, has not achieved the goal of efficient growth as is usually claimed on its behalf. It is only the service sector which has seen a remarkable upsurge, much to its leanings on the IT sector, the latter with an annual growth of 11% during 2006-07 and contributing more than half (54%) of the annual GDP with an export growth rate of software at 75% . However, the prosperity in the services sector, as mentioned

[14] See, for details, Sunanda Sen and Byasdeb Dasgupta, 2009.

above, was mostly confined to IT and finance, with Business Processing Organisations (BPOs) in the IT sector responsible for outsourcing of services for overseas companies. As mentioned above, these services were made possible with the country's track record of skill formation during the earlier years along with the newly accessed technology.

The service sector in areas of finance could take off as a result of financial liberalization which allows the free entry and exit of foreign capital and their deployment along different channels. A major consequence of the latter has been the sharp volatility in stock prices and even in exchange rate, volatility of which has been a common feature. Short term flows of capital have been responsible for an added degrees of uncertainty in the financial market which, paradoxically, provides further incentives for short term inflows in a booming market. The pattern with a boom has been in the reverse gear when stock prices moved in the downward direction, reinforcing flows of capital in the outward direction. The unprecedented accumulation of exchange reserves by the country, which is currently around $300bn often generates a sense of complacency for monetary authorities, calling for a move to full capital account convertibility of the Indian rupee and even investments in the equity-linked Sovereign Wealth Funds (SWF). Pressures from the WTO in terms of the GATS to open up the services sector including banks and the insurance sector has provided a major incentive to foreign finance.

However, in terms of employment potential, the contribution of services had been abysmally low, providing not more than 1% of jobs in the organized sector

The structural shifts in the economy, away from brick and mortar industries and from agriculture, in the direction of the sun-rise services sector, while generating high growth rates of GDP, proved a failure in terms of employment growth. One thus observes a scenario of 'job-less growth', with employment in organized industry and services growing at around 1% per annum. The pattern even prevails in the high growth industries with annual average output growth at 20% and above and employment growth falling far behind. The arithmetic behind it is the rise in labour productivity which was made possible by raising capital-intensity per unit of labour[15]. In absence of offsetting factors which included expansions in the scale of production of these units, employment growth in industry failed to keep pace with output growth, even in units where these were robust. The core dynamic sector of the Indian economy today consists of IT and finance in the services sector, which so far has a limited capacity to absorb greater numbers, especially from the majority in the country who possess neither the requisite skill nor the resources to access skill-formation.

It thus remains for agriculture and the informal sector in both industry and services to fill in the vacuum in the job-less market laden with the so-called flexible norms for the labour market. These are the sectors which continue to support at least 75% or more of India's working population who live in the countryside. But the slow or even negative growth of agricultural output in recent years, along with the use of new technology in terms of fertilizers etc. as are needed for the new crops, have made agriculture less dependent on labour as an input, especially in North India. But that does not reduce the dependence, of large numbers of people in the countryside, on avenues of subsistence around this sector. Annual growth rates of agricultural output reflected a dismal picture in recent years, with low growth in several years of the new millennium. Facts as above along with jobless industry explain poverty, with one third of population living on \$1 to \$2 dollars per day and with their well being as indicated by the rank of India in global human development index as low as 123 in recent times.

8. Public Protests, Responses from the State

Unemployment, poverty, malnutrition, rising food prices and shortages, agrarian distress and farmer suicides, widening disparities and aspiration gaps prepare the grounds for protest movements which have been widespread in recent years. Contrasts between the

[15] Ibid.

high-income consumptions in pockets of the economy and abject poverty as well as acute distress for the majority created an atmosphere of growing discontent and anger at a scale which was not witnessed before. Mention can be made of various organizations from the civil society, with demands which range from employment, food under public distribution, primary and other education, abolition of child labour, displacements by big dams, industrialization by the setting up of Special Economic Zones, rights of women, trade unions rights for casual labour and similar issues which are important. Sometimes these demands are also voiced by political parties in the opposition, attacking the policies of the party in power but co-opted by mainstream thinking when they come to power in individual states.

Demands as above unfold a story which speaks of a total denial of developmental needs and equity in the country. However, to continue with the minimal façade of democracy by an elected government, the ‘double movement’ of Polanyi under capitalist expansion keeps repeating, despite the innate apathy on part of the authority in power, which introduced reforms in a remedial mode. Of late these include in India the National Rural Employment Guarantee Act (NREGA), the Right to Information Act (RTI), Farm loan waiver scheme, Anti-hoarding drive to combat food prices and the frequent announcements by those in power to endorse an ‘inclusive development’. The changed mood also reflects itself in the moves on the part of the private sector to shoulder a minimal corporate social responsibility. While none of these are supposed to halt the steady advances of the market or to attack the roots of poverty in the country, the moves continue to remain as symbolic gestures which help to bring back some minimal semblance between growth and equity or development.

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Chapter 6

The Origins of Economic Orthodoxy in Mexico[1]

María Eugenia Romero Sotelo

1. Introduction

This article supports the hypothesis that the formation of an an economically orthodox current in Mexico was a conscious act by a sector of Mexico's élite, intended to create an alternative to what has been called economic nationalism, which emerged with the Mexican Revolution of 1910 and was consolidated by the economic and social reforms promoted by President Lázaro Cárdenas (1934-1940)[2]. In the

[1] A Spanish version of this article has been published in the Journal *Economía UNAM*, vol. 8. No.24, 2011.
[2] This article is the result of my research visit to the Instituto de Estudios Latinoamericanos (IELAT) at the Universidad de Alcalá, as part of the Short-Stay Post-Doctoral Research Programme organised by Fundación Carolina and the Department of Academic Staff at the Universidad Nacional Autónoma de México (UNAM). My gratitude to all three institutions. I would like to extend particular thanks to: Pedro Pérez Herrero, Director of IELAT, for his commitment to my research programme; to my colleagues and friends Leonor Ludlow, Carlos Tello, Enrique Rajchenberg, Juan Pablo Arroyo, Emilio Caballero and Rogelio Huerta, for the time and effort they were willing to put in to reading this article, and for their intelligent and thought-provoking comments; and to Samuel Luna Millán, for his support in carrying out this research. Finally, I would like to mention that this work is part of a line of research developed by the project PAPIIT IN307408

word of the researchers: the Revolutionary movement set Mexico on the road toward the economic doctrine that would prevail in Western economies in the post-War period, and it was during Cárdenas's administration that the biggest steps were taken[3].

In December of 1934, General Lázaro Cárdenas was sworn in as President of the Republic, and he undertook a series of wide-ranging structural reforms intended to resolve social problems and encourage growth and economic development in Mexico. Within this programme, the State played the pivotal role as promoter of development. The plan was a turning point in Mexican economic thought, as it broke with the liberal-style economic policy that had been dominant in Mexico since the Revolution in 1910, even during periods such as the crisis of 1929. From that moment on, two different ways of approaching and resolving the problems of the Mexican economy would remain in tension with one another for the rest of the twentieth century.

The Cardenist economic policy of growth with distribution of wealth was not looked favourably upon by a particular class of business owners. The State played a very active role in the economy in its quest for independent, nationalistic economic development, and all of this implied: a renewed impetus for agrarian reform (a wide-reaching redistribution of land), and consequently the redistribution of the nation's wealth; and support for workers' interests through the formation of trade unions and respect for the right to strike. The policy encouraged economic activity via a broad programme of public investment, which in turn was responsible for the construction of large public infrastructure projects. To this end, a group of public institutions was created to manage and guide the economy, including the development bank Nacional Financiera and the agricultural lending institution Banco de Crédito Ejidal. In 1938, Cárdenas national-

"Philosophy, Figures and Institutions in Mexican Economic Policy, 1880-2005".

[3] See Loyola & Martínez, 2010, p. 27.

ised the oil industry and created the state-owned oil company Petróleos Mexicanos (Pemex)[4].

The economic philosophy that emerged from this era constitutes the basis of Mexican "developmentalism", characterised by State intervention to ensure high growth rates, the distribution of revenues and job creation[5]. The approach was most closely identified, at that time, with Eduardo Suárez, the Finance Minister under Presidents Lázaro Cárdenas and Manuel Ávila Camacho, and this school of thought, with varying interpretations, dominated and permeated Mexican economic policy for much of the twentieth century until the beginning of the nineteen-eighties.

This policy upset economic interests and gave rise to the deliberate construction of an alternative to Cárdenas's approach, consisting of the reconstitution of the liberal movement that had dominated the country's economy from the end of the nineteenth century to the end of the nineteen-thirties. Throughout the time that 'developmentalist' thought was being formed and evolving, orthodox economic thinking was also present, and it laid down tenets at the same time that it was establishing institutions within the country. This eventually created the conditions for neo-liberalism to come to the fore in the nineteen-eighties. This paper will attempt to answer the following questions: How did orthodox economic thinking come

[4] "From 1934, he undertook considerable structural reforms. Beginning during his campaign, he adopted a model of economic planning, expressed in the First Six-Year Plan, that was inspired by Soviet planning. President Cárdenas also created institutions and a legal framework to sustain his economic policy: in 1935, he established the Department of Hunting and Fishing, the Forestry Department and the Department of Indigenous Affairs, followed by the National Deposit Stores in 1936; in 1937, the National Bank of Foreign Trade and the National Workers' Industrial Development Bank were founded, and the New Insurance Law was passed. In 1939, the National Housing Commission was created, among other institutions." Loyola & Martínez, "Guerra", 2010, p. 23.

[5] For a full description of Mexican "developmentalism" (desarrolismo), see Suárez, "Dos visiones", 2005, p. 229. For an overview of the economic theories of Lázaro Cárdenas, see Guerrero, "Pensamiento", 2005, p. 189.

about in Mexico? And how was orthodox thinking able to develop in Mexico, with Cardenist-Keynesian philosophy so dominant on the economic political scene?

Orthodox liberal thinking, in the opinion of Francisco Suárez, began to develop in the decades of the nineteen-twenties and thirties[6]. My personal view is that this school of thought is a continuation of the liberalism that prevailed during the reign of Porfirio Díaz at the end of the nineteenth century, updated with new developments from the liberal school of the nineteen-twenties, in particular the Austrian School, put forward by Friedrich von Hayek and Ludwig von Mises. This approach was adopted and promoted in Mexico by Luís Montes de Oca[7] and Miguel Palacios Macedo, who believed that price stability should be the foremost objective of economic policy. The intellectual talents of these two figures were complemented by the pragmatic approach of businessmen such as Raúl Baillères

[6] For a description of Mexican orthodox thinking, see Suárez, “Dos visiones”, 2005, pp. 228-229.

[7] Luís Montes de Oca was Minister of Finance and Public Credit from the 16th of February 1927 to the 20th of January 1932. He occupied the post during the administrations of three Presidents: for a year and two months under Plutarco Elías Calles; for a year and two months under Emilio Portes Gil; and for eleven months under Pascual Ortiz Rubio. Eduardo Villaseñor describes him as a classical liberal and staunch opponent of any official intervention to influence the national economy. He also had strong links to two of the representatives of the liberal orthodox current of the moment, with whom he maintained a correspondence: Ludwig Von Mises and Friedrich Von Hayek. Aníbal de Iturbide describes him as “an extraordinarily cultured man, and one with good relations with other talented men”. He was a natural leader and his opinions held a great deal of influence in intellectual and business circles in the country. He created and developed an ideology for these groups. He was Minister of Finance in the midst of the depression in the nineteen-thirties, in response to which he defended a balanced budget and “healthy finances”. He was also Director General of the Bank of Mexico, and in this position he refused to provide support for the financial deficits required by Minister of Finance Eduardo Suárez to expand the economy during the administration of Lázaro Cárdenas. *Ibid.*, p. 227.

and Aníbal de Iturbide. These figures are fundamental to an understanding of the roots of orthodox thinking in Mexico, as well as its development and the consolidation of its power during the last century.

Together, they began the task of establishing institutions that would counteract Cardenist principles in the economy and in politics. In academia, they founded higher-education institutes that provided an alternative to the leftist ideology in state universities, specifically the ideology of the School of Economics of the UNAM, founded in 1929 by a group of nationalist intellectuals.

During this process of the formation of the school of orthodox economic thought in Mexico, Ludwig von Mises and Friedrich von Hayek had considerable intellectual influence. Both belonged to the socalled Austrian School, and the two professors were firmly opposed to any kind of planned economy, associating freedom with the market. They gained their position of influence in Mexico as a result of the fact that they helped to reinforce the approach and the rhetoric of the groups of business leaders and intellectuals who rejected the trend of economic nationalism. The question that arises is: How did the Austrian School and the resistance against Cardenism work together? Within the group of Mexican intellectuals, the leading role was played by Luís Montes de Oca. He studied the work of Mises and Friedrich von Hayek, established a relationship with them, and they encouraged his ideas from an intellectual standpoint. Raúl Baillères, one of the group of pragmatic business leaders, provided financial support for the project. Together, these individuals constructed and breathed political life into the school of liberalism in this country.

2. An Alternative to Cardenism: Von Mises and Von Hayek

The rallying point in the intellectual debate between Luís Montes de Oca and the two professors from the Austrian School was the criticism of a planned economy that entailed very active intervention on the part of the State in the country’s economic affairs. This was condemned by all parties from the standpoints of both theory and policy. In Mexico, with the economics of Cárdenas, the notion had been established of planning with State intervention (the Six-Year Plan), and this gained currency in many so-called Third-World countries in the period following the Second World War. The opinions of Montes de Oca and his familiarity with the two representatives of the Austrian School are made clear in an article, "State Intervention in Economic Activity", published in the year 1943[8].

Montes de Oca and Von Mises met in New York in the winter of 1941. The former then invited Mises to visit Mexico for a series of conferences at the Universidad de México, and offered him excellent conditions if he were to extend his sojourn. In her memoires, Margit von Mises, wife of Ludwig, recounts:

He offered Lu a lifetime position, a house with garden, a car and chauffeur, and tremendously high salary if Lu would accept his proposition. But Lu refused. He was happy to come as a guest, but he remained firm in his decision to make his home in the United States[9].

Despite such an attractive offer, Mises declined the proposal of the former Finance Minister. A year later, at an encounter in Manhattan, Montes de Oca again invited him for a period of two months and they discussed the possibility of having his book *Socialism* translated into Spanish. This would eventually be published in Mexico in 1961, two years after Montes de Oca's death.

While war raged on the international stage, on the 11th of January 1942, Von Mises arrived in Mexico in the company of his wife Margit and remained in the country until the 25th of February of that year.

The couple was received by a group of university professors and lodged at the Ritz Hotel in Mexico City. Mrs. Mises gives a description of the reception they received at the hotel and her impressions of the following weeks:

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[8] Montes de Oca, 1943, pp. 225-264.

[9] Von Mises, 1976, p. 75. Margit referred to her husband Ludwig Von Mises as "Lu".

> Our suit… was so full of roses, gardenias, and white callas I thought I was back on the stage.
> The subsequent seven weeks… were perhaps the greatest surprise of my life. Not only because Lu, for the first time since we had left Europe, got the recognition he deserved, but because the high intellectual standard of Mexican elite, whom we had the privilege of meeting during our stay, was absolutely overwhelming to me[10].

A group within the Mexican élite much admired the contributions that Von Mises had made to economic theory. In Mexico the Viennese professor seemed to have achieved a level of recognition that he did not yet enjoy in the United States. Mises's wife comments that Montes de Oca was already familiar with Mises's work when they met, as we have already mentioned. It is possible that Montes de Oca introduced other members of the Mexican élite to the theories of the Austrian School.

Mises began his series of conferences on the 14th of January, at the school of economics of the UNAM and at the Escuela Libre de Derecho. Between 8 and 14 students attended the lectures, which were given in English. Montes de Oca himself acted as translator.

During his stay in Mexico City, Mises would meet Montes de Oca at the latter's house at night. During these gatherings, Mises expressed again and again his pessimism about the future of society. Montes de Oca, on the other hand, insisted on his optimism. He believed that it was not too late to fight for freedom and was firmly convinced that Mexico was the ideal place to start.

The Association of Mexican Bankers, which was presided over by Raúl Baillères, also convened two conferences that were given by Von Mises. The first of them was on the topic of "Banking and Economic Policy in Our Time"; the second was "Planning and

[10] Ibid.

Banking". These conferences were held in the auditorium of the Confederation of Chambers of Commerce in Mexico City[11].

Two of the most prominent associations of Mexican business leaders, the Association of Mexican Bankers and the Mining Industry Confederation, asked Von Mises to extend his stay and offered him employment as an economic adviser. He asked for more information about the duties he would be expected to perform. Six months later, Montes de Oca made him the following proposal:

According to his proposition, Mises would become the head of the economics departments of the two business associations, with sufficient personnel to assist him and at a comfortable monthly salary of 1,000 Mexican pesos (a lunch for one person at the Ritz costs three or four pesos). He would also be teaching courses and seminars at any department he wished at the National University of Mexico and at the Colegio de Mexico, and he would be free to take up other (paid) teaching assignments. The offer was for three years and could become effective any time – Mises would not even have to return to the United States after his upcoming visit[12].

Once this offer had been received, Mises became interested in knowing more about the situation of the Mexican economy. In a letter to his friend Hayek, he describes the opinion of Mexico that he formed during his trip:

> Mexico is a country without industry and very short of capital. The soil is in the greater part of the country very poor. The result... is that they have to import wheat and mais [Mises meant what Americans call "corn"], but the rulers – generals, trade union leaders and pink intellectuals – intend to start industrialization by ruthless confiscation of capital. Neither this attitude nor its effects differ from conditions in other countries. But really amazing is the fact that there are some people – of course

[11] El Nacional, 16th, 20th, 21st of February 1942. The Association of Mexican Bankers was founded in 1928.
[12] Hülsmann, 2007, pp. 813-814.

> a small elite only – who have a very keen insight into the problems involved and try to educate the intellectuals[13].

Two things are immediately notable in this letter to his friend: first, the description that Mises makes of the Mexican economy (poor and without industry), combined with infertile farmland and the existence of an industrialisation scheme sponsored by trade-union leaders and intellectuals based on what he refers to as the "confiscation of capital". Secondly, Mises is intrigued and surprised to note that there is an élite in Mexico that is opposed to the Mexican government's policy and that is attempting to create an intellectual movement in favour of its own arguments. In this latter aspect, both Mises and Hayek went on to play a fundamental role.

Following this first visit, Mises and Montes de Oca maintained an intense and fruitful correspondence.

In the month of June 1942, Montes de Oca proposed to Mises the establishment of the Instituto Internacional de Ciencias Sociales, which would be under his direction, and in 1943 he informed Mises that considerable progress had been made on the project. In the same letter, he also asked for suggestions as to what teachers might be willing to work for the institute, and the salaries that they would command:

Mises replied that Walter Sulzbach, Alfred Schütz, Louis Rougier, Jacques Rueff and he himself – all European expatriates living in New York without American citizenship – would be available for permanent employment in Mexico City for an annual compensation of some $ 6,000 per head. This was a fairly generous salary, and proved to be a major stumbling block for the establishment of the Institute. But in early 1943 everything seemed possible: a group of first-rate intellectuals with classical-liberal pedigree was at least potentially available and another group of men was interested in financing the venture. Moreover, there was a plan: Louis Rougier would be invited to the University of Mexico City for a series of lectures; Mises was to prepare a study on Mexican politico-economic condi-

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[13] Ibid., pp. 814-815.

tions (which Montes de Oca had commissioned for his Banco Internacional); and Montes de Oca continued to work on a translation of Socialism[14].

The subjects they would teach were: economics; history and critical analysis of the economic doctrines of the last two centuries; constitutional history since 1776; economic and social history since 1750; and modern public finance.

Mises began to take on a role as intellectual adviser to the Mexican élite with Montes de Oca as his intermediary, which he makes reference to in his letter to Hayek. He was consulted in connection with the formation and development of what was later to become the movement's most important educational project: the Instituto Tecnológico de México.

3. An Economic Policy for the Post-War Period: Von Mises

At the end of the month of February 1942, Mises left Mexico with a promise to write an article for the magazine *Cuadernos Americanos*[15]. He was true to his word, and "Ideas on Post-War Policy" was published in the July-August edition (number 4) of the magazine in that same year. In the article, Mises reflects on the economic policy guidelines that in his opinion different nations should follow to rebuild their economies in the post-War period.

The war did not put a stop to intellectual endeavour; on the contrary, many intellectuals poured their energies into reflections on what the respective virtues and defects were of the different political regimes at large in the world, and which had clashed in the Second World War: socialism, fascism, communism, liberalism. Among these thinkers were Joseph Schumpeter, Karl Mannheim, and Karl Pop-

[14] Ibid., p. 827.
[15] A magazine of social sciences and philosophy, founded and edited by Jesús Silva Herzog.

per; Friedrich von Hayek and Mises also took part in this collective meditation[16].

In his article, Von Mises maintains that to rebuild their economies, nations should follow a policy that was radically different from the one used before the start of the war. He was specifically referring to economic nationalism, which he believed detrimental to economic development. He describes it as:

> …An economic policy based on the belief that it is possible to promote the wellbeing of all the subjects of a nation, or at least a specific group, by putting into practice measures that are disadvantageous to foreigners. It was believed that a service was being rendered to one's country by obstructing or completely prohibiting imports of foreign products, restricting foreign immigration or expropriating, in part or in full, the capital belonging to foreigners. This is not the place to undertake an investigation of whether measures such as these were in fact ideal for the purposes of achieving the desired outcome. Classical free-trade theory has now provided irrefutable proof that the end result of restrictions on foreign commerce is none other than a generalised decrease in the productivity of labour and, therefore, of the standard of living. Thus, production ceases in places where it could create large yields, and is transposed to other locations where, with a minimum of effort on the part of both capital and labour, far lower returns are obtained. The classical theory of free trade espoused by Hume, Smith and Ricardo has never been refuted. Every postulation made against it has subsequently proved to be unfounded[17].

Mises maintained that the elimination of economic nationalism was a precondition for nations to achieve peace and wellbeing in the post-War period. He believed that the essential problem of the post-War economy was a shortage of capital, and for him the only way to alleviate this ill was:

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[16] Watson, 2003, pp. 405-406

[17] Von Mises, 1942, p. 88.

> …to produce more than is consumed, that is, to save and thereby to create new capital. The more is produced, and the more of what is produced is invested and the less consumed, the faster will the difficult times of lack of capital pass. Anyone who advises a different solution to the one that we have just explained is deluding himself, or is trying to delude others[18].

He goes on:

> There are no magical financial procedures to ease the lack of capital. The expansion of credit cannot alleviate it, much less eliminate it. On the contrary, a boom artificially created by an expansion of credit may lead to a lack of focus, and therefore a squandering of capital, by immediately favouring overconsumption, that is, the consumption of capital. Inflationary experiments will do nothing but worsen the crisis. What is needed in this case is, precisely, a monetary and credit policy that ensures the stability of monetary value[19].

Mises was of the opinion that governments should abandon their confiscatory policies and radically change their taxation policies. He proposes that:

> …the part of revenue that is not consumed, but is saved and invested, should be free from all taxes, since it is in the public interest that as much new capital be formed as possible[20].

To conclude, Von Mises's proposal for the policy for reconstruction following the Second World War was to bring to an end the economic nationalism that had entailed a policy of protectionism, as well as a taxation policy that, in his opinion, did not allow an increase in savings and the formation of capital. Economic reconstruc-

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[18] Ibid., p. 93.
[19] Ibid., p. 93.
[20] Ibid., p. 94.

tion, in his opinion, had to be lit by the glow of the free-trade paradigm.

4. Von Mises and the Economic Problems of Mexico

Also resulting from his trip to Mexico was the essay Economic Problems in Mexico, written in 1943, in which Von Mises put forward a critique of Mexican State economic policy since the Revolution of 1910. The essay was published by the Instituto Cultural Ludwig Von Mises in 1998, with an introduction by Carolina R. de Bolívar. In the year of publication, she was the Academic Director of the Instituto Josefina Vázquez Mota and a notable member of the Partido Acción Nacional political party.

Bettina Bien Greaves, a distinguished student of Von Mises, presented the institute with the text of this publication as a gift, after inheriting from Ludwig and Margit von Mises all the documents that they left behind in their New York apartment when they died. Margit von Mises describes the role that Greaves played in their lives as follows:

> …She first came to the seminar in 1951 and attended it to the last session, not missing a single meeting. She is one of those rare individuals who combine intelligence and mental curiosity with warmth and understanding of human nature. With the passing of the years, she became a household ward with Lu and me. If there was any information Lu needed, any refreshing of his memory, he would say, "Call Bettina" and surely enough she had the answer[21].
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> After four or five years in the seminar, Bettina took her seat next to Lu, taking notes in shorthand – and no one would have dared to contest for that seat. I spoke first to Bettina in 1952 during a seminar in California. At the time she was still rather quiet, hardly asking any questions, but later, working with

[21] Von Mises, 1976, p. 140.

> tremendous zeal, studying Lu's books from beginning to end, reading them again and again, her inner security grew in relation to her knowledge. She wrote an excellent bibliography of Lu's work, and for his ninetieth birthday she catalogued – with my permission and without Lu's knowledge – his whole library of about 6,000 volumes, to Lu's greatest surprise and delight[22].

Bettina Bien Greaves was very familiar with the Mises library, which she also inherited when the couple passed away. This explains her finding the documents where Mises analysed the Mexican economy, and which make up the content of Mises's previously unpublished article on Mexico.

In "Economic Problems in Mexico", Ludwig von Mises challenges the economic policy measures implemented by President Lázaro Cárdenas during his administration. His criticism centres on: State intervention, inflation, protectionism and economic nationalism[23].

Before turning to an analysis of Mises's arguments, it is important to note that when Mises visited Mexico, the country was under the administration of President Manuel Ávila Camacho (1940-1946) and the Second World War was being played out internationally. The war created favourable conditions for the industrialisation of the country, by increasing demand for Mexican manufactured goods on the international market. The most salient features of the industrialisation project then under way were: a very active role for the State in the economy, protectionism, the granting of tax incentives and the creation of infrastructures.

In his essay, the author takes as his starting point the argument that Mexico is a backward country and that industrialisation is the key to solving the problems of economic underdevelopment, although he states his opposition to the industrialisation policies of the Mexican State, which are based on considerable State intervention

[22] Ibidem.
[23] Von Mises, 1998.

and protectionism. With reference to the period of nationalization under Lázaro Cárdenas, he comments that Mexico needed capital for development and that these nationalisations scared it away:

> What Mexico needs more than anything else is capital, either of its own or from overseas. The default on the national debt and the expropriation of foreign investments discourage the external capitalist, and the methods of taxation obstruct the accumulation of internal capital. Complete renunciation of these practices is the first requirement for the economic regeneration of the country.
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> There is no hope of building prosperous industry in a country that considers every businessman as exploitative and tries at every turn to punish his success. The policy of shortening the working day and driving up costs, by forcing the entrepreneur to provide housing for his workers and establishing minimum wages, either due to the direct interference of the government or by failing to reign in the demands of the unions, is foolhardy in a country whose industrial base has yet to be created.
>
> It is an unfortunate reality that a country that has less favourable natural conditions for production than others, and that suffers from a comparative lack of capital, has just one way in which to compete with countries that have been more blessed by nature and are richer in capital: a cheaper workforce. In a world with no barriers to immigration, there is a tendency to put salaries in different countries on a par with one another. If there is no freedom of movement for workers, however, salaries must necessarily be lower where natural resources are scarcer and capital less abundant. There is no way to change this fact. If the government or the trade unions are unwilling to accept this reality, not only will they fail to improve conditions for the masses, but they will make them worse. They will hinder the development of manufacturing industries, condemning workers to persist as agricultural labourers in extreme poverty, when they could have better-paid employment in factories.
>
> The only way to improve the economic situation of Mexico is through economic liberalism: that is, a policy of *laissez-faire*... to envy the success of one's more fortunate countryman is a common weakness among men. But an honourable patriot

> should not look upon the fortunes of efficient entrepreneurs with distaste. He must understand that, in a capitalist society, the only way to accumulate wealth is by supplying consumers with the goods that they demand, at the lowest possible cost. He who serves the public best, is best rewarded. What Mexico needs is economic freedom[24].

In general, then, the developmental policy of the Mexican State was disparaged by Mises: the specific targets of his criticism were the protection of the internal market, wage and union policies, and the intervention of the State in the economy.

5. The Institutions: the Asociación Mexicana de Cultura

A group of businessmen, headed by Raúl Baillères, was interested in providing an alternative to the economic policy that had prevailed in Mexico since the administration of Cárdenas[25]. In 1946, the institution that would become the standard-bearer for this alternative project was founded: the Asociación Mexicana de Cultura. Formally, it was created with the aim of: initiating, promoting, stimulating, sponsoring, or directly administering and directing educational and

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[24] Von Mises, 1998, pp. 12-13.

[25] At a later date, both the old-guard industrialists and bankers would play a role in the establishment of higher-education institutions that provided an alternative to what they perceived as the leftist ideology prevalent in State-regulated universities. The Instituto Tecnológico y de Estudios Superiores de Monterrey (ITESM), founded by local industrialists in 1943, placed emphasis on technical fields of study, such as engineering and business administration. Inspired by the institutes of technology of Massachusetts and California, the “Tec de Monterrey” would not have an economics department until 1954. Another private university, the Universidad Iberoamericana, was also founded in the nineteenforties with a conservative, Catholic ethos, and did not open an economy department until the nineteen-sixties. Babb, Proyecto, 2003, pp. 98-99.

cultural activities of all kinds[26]. Its founding statement explains that, in order to comply with its fundamental purpose of promoting education in Mexico, the Asociación Mexicana de Cultura undertook to:

> …establish a system of higher-education campuses that are free to exist with no obligations other than to the laws of learning, and with complete academic liberty; with no purpose other than the discovery of the truth and the education of young people; removed from any dependence on militancy or group politics; free from the vicissitudes of financial hardship; capable of providing, within a strict framework of order and discipline, new opportunities for the youth of Mexico in efficient cultural education, scientific instruction, technical training and research; that guarantees for its faculty members an honourable life and their enthusiastic and exclusive dedication to teaching; and which encourages equally the complete education of the young person in aspects cultural, scientific, technical, sporting and, essentially, moral and patriotic[27].

Among the founders of the Asociación Mexicana de Cultura we find seven of the country's largest banks and several businesses based in Monterrey, including the brewery Compañía Cervecera Moctezuma and the iron and steel producer Compañía Fundidora de Fierro y Acero de Monterrey[28].

The prominent individuals that took part in the formation of the Association include: Mario Domínguez, Luís Montes de Oca, Ernesto Amescua, Aarón Sáenz, Evaristo Araiza, Federico T. de Lachica, Julio Lacaud, Manuel Senderos, Pedro Maus, José de la Mora, Emilio Souberville, Hipólito Signoret, Guillermo Barroso, Carlos Gómez y Gómez, Manuel Ulloa, Carlos Trouyet, Rogelio Azcárraga, Aníbal de Iturbide, Enrique González Rubio, Carlos Novoa, Antonio Díaz Lombardo, Salvador Ugarte, Noé Graham Gurría, Fernando A. González, Bernabé A. del Valle, Manuel Sand-

[26] Negrete, 1988, pp. 9-11.
[27] El Universal, 26th May 1946, p. 10.
[28] Ibid.

oval Vallarta, Eduardo García Máynez, Antonio Martínez Báez, Fernando Orozco, Gustavo R. Velasco, Mariano Alcocer and Virgilio Domínguez. The Association's first board of directors was comprised of businessmen, bankers and individuals who had pursued careers in both the public and private sectors[29].

The Association's founders considered that their most pressing task was to cultivate institutions that would promote technical training with a human touch among young people wishing to go into professions in the banking, industrial and commercial sectors[30]. For this reason, they chose to establish:

a) The School of Industrial Engineering, which offered courses in mechanical, electrical, chemical and administrative engineering.

b) The Mexican Institute of Economics, where students could study bachelor's and doctorate degrees in economics, or to become statisticians or actuaries.

c) The School of Administration, which trained students to become accountants and business administrators in the banking, industrial and commercial sectors.

The Association also offered short specialisation courses for executives and employees in banking, industry and commerce, with the aim of promoting technical innovation and cultural development[31].

The educational institutions that were created on the basis of this platform would be administered by a Technical Advisory Commission made up of university academics, including: Dr. Manuel Sandoval Vallarta, Dr. Fernando Orozco, Virgilio Domínguez, Antonio García Báez, Gustavo R. Velasco and Mariano Alcocer. Eduardo García Máynez was appointed Director General[32].

The creation of the different schools was seen as, or was portrayed as, "...the first major step by private enterprise in favour of

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[29] Ibid.
[30] Universal, 12th January 1947, p. 11.
[31] Opción, 1988, p. 5.
[32] "La Asociación Mexicana de Cultura va en auxilio de la Universidad", El Nacional, 24th June 1946, p. 6.

cultural refinement, in a spirit of cooperation with the National University of Mexico and with the aim of solving problems of overcrowding in classrooms"[33]. This account was contested by Gilberto Loyo, then the Dean of the National School of Economics at the Universidad Nacional Autónoma de México, who claimed that his school in fact had a shortage of students[34].

6. Creation of the Instituto Tecnológico de México

The Asociación Mexicana de Cultura eventually achieved its objective and created the Instituto Tecnológico de México (ITM), later known as ITAM, whose core programme was the study of economics and which was organised as an alternative to the programme of studies at the UNAM's School of Economics. In 1946, the Asociación Mexicana de Cultura opened its rival School of Economics, which followed the study plans and programmes that were in use at the National University with some minor adjustments in the order of the various subjects, but without eliminating any of them[35].

It might be considered curious that the School of Economics at the ITM chose to follow the curriculum and programmes of the School of Economics at the Universidad Nacional Autónoma de México, if it had been created as an alternative to the latter. When the news broke, some people espresse doubts about the new educational institution: *Why would the country's bankers want to create another school of economics? Would it not be better for them to provide financial support for economic culture through the institutions that already existed[36]?* The answers to these questions would later on be provided by the founders themselves of the institution in question.

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[33] Ibid..
[34] "Economistas", El Tiempo, 15th March 1946, pp. 29-30.
[35] El Universal, 6th January 1948, p. 7.
[36] Revista de Economía Continental, vol. 1, no. 1, 15th August 1946.

Dr. Josué Sáenz, a lecturer at the School of Economics and the Director of Statistics at the Ministry of the Economy, was the first person that the bankers asked to be Director of the Mexican Institute of Economics. He turned down the position. The appointment was then conferred on Daniel Kuri Breña, a close collaborator with the Partido Acción Nacional and someone, therefore, perhaps much more ideologically aligned with the founders' plans[37].

In an interview in 1988, one of the founding partners, the banker Aníbal de Iturbide, gave some insight on the set of circumstances that persuaded the group to create the Asociación Mexicana de Cultura and the Instituto Tecnológico de México. In his words:

> [In 1946] at the end of the presidency of Manuel Ávila Camacho… there was a Cardenist ideology that was still very much in vogue, which was, in our opinion, misguided. The notions of governance of General Cárdenas were still exerting a great deal of influence on the ideological development of politics and the Mexican way of life, which we believed was not the best way to go about seeking the balanced development of the nation.
>
> So a group of us, those of us that organised the Asociación Mexicana de Cultura, were of the opinion that if we were to promote industrial development in Mexico, we would have to try to change the mentality of the people, because with a mindset that was predominantly socialist and left-leaning in nature, which was the most dominant ideology in politics, we did not believe that industrial development was possible. It was not possible for the existing climate to be conducive to capital investment, either Mexican or foreign, to allow Mexico to begin a new predominantly industrial stage in its development.
>
> That was essentially the reason why we decided to found the Instituto Tecnológico de México, with the aim of creating a school of economics to educate the men who would in the future administer the private and public finances of Mexico...[38]

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[37] "Economistas", El Tiempo, 15th March 1946, pp. 29-30.

[38] Negrete, 1988, p. 9.

According to de Iturbide's account, the idea began to form during the administration of General Lázaro Cárdenas, when the group of businessmen in question began to realise that Cardenist policy was at odds with their way of thinking. He says:

> We believed that with Cardenist ideology in full force, there was insufficient incentive for the large-scale capital investments that were needed to begin the process of transforming the country from one that relied on agriculture, fisheries and mining to one that was
> industrialised.
> We decided not to go ahead with the School of Engineering because we came to the conclusion that we would not be effective if we tried to include too many branches. Instead we chose to focus on three or four schools, with preference always for the School of Economics, because it was our belief that this would be the base on which the future of Mexico would be built[39].

The chief proponents of the ideology of State intervention espoused by Cardenism, which was so criticised by Iturbide and his partners at the Asociación Mexicana de Cultura, were the National School of Economics at the UNAM and its academics. Many of the latter belonged to the economic nationalist movement, and had the objective of implementing the programme that was fought for during the Mexican Revolution, which would later evolve into a policy for economic development. Some of them were: Jesús Silva Herzog, one of the founders of the National School of Economics; Enrique González Aparicio, Ricardo Torres Gaytán, Horacio Flores de la Peña and Emilio Mugica. They were all deans of the School, held high-level positions in the public sector, and played important roles in the public sphere. At the National School of Economics, these professors recruited students for the public sector, while simultaneously creating the professionals that the 'developmentalist' State needed for

[39] Ibid. p. 10.

administrative purposes[40]. According to research carried out by Roderic Camp:

> Graduates of the National School of Economics have tended to concentrate heavily in two government agencies: The Secretariat of Industry and Commerce, and the Secretariat of the Treasury. There are several reasons for this concentration. As is evident … leadership of those agencies has been dominated by professors or graduates of the National School of Economics from 1929 to 1951[41].

An interesting case is that of Gilberto Loyo:

> …who became dean of the School of Economics in 1944, gave a great impetus to the career of being an economist by encouraging the employment of economists in the Secretariat of Industry and Commerce, which he headed in 1952 after leaving the deanship. Control of this agency by National School of Economics graduates has continued until 1974. The establishment of a federal Income Tax Department in the secretary of the treasury, which almost exclusively employed economists… was soon directed consecutively by National Economic School graduates. Lastly, when costudents and professors recruited students, it was often into their own agencies[42].

It was in opposition to this school of thought that the liberal project headed by the group of businessmen in question began to create alternative institutions. In an article published in the magazine *Tiempo* on the 15th March 1946, a quote was printed from one of the founders of the ITM – who was not identified, but who was part of the so-called BUDA group (the cabal formed by bankers Raúl Baillères, Salvador Ugarte, Mario Domínguez and Ernesto J. Amezcua) – which said: “We need liberal economists uncontaminat-

[40] Camp, 1975.
[41] Ibid., p. 147.
[42] Ibid.

ed by interventionism, who defend our interests in opposition to the State"[43].

The unnamed source went on to criticise the National School of Economics:

> ...the National University and its School of Economics [are] in a permanent state of disorder, and as for the latter, which is possessed by statist ideology, it is incapable of guaranteeing the creation of well-educated, technical economists that may be entrusted with positions in banking and private enterprise without raising concerns[44].

Gilberto Loyo, Dean of the National School of Economics at that time and a professor of statistics and demographics at the same institution, responded to this statement from a purely academic viewpoint:

> It is false to claim that at this institution we provide an ideologically doctrinaire professional education. The academic freedom enjoyed by teaching staff at the UNAM allows for the National School of Economics to be exposed to all schools of thought, and this is in fact the case. However, what we do aspire to is for graduates of our institution to be capable of serving the nation and not just a specific social class. We have also made sure that our
> study plans are standardised, so that students can apply their know-how effectively, independently of whether or not they nuance them with their own purely personal opinions[45].

The statement issued by the businessmen could not be clearer in relation to their motives for establishing the ITM: in their opinion, only a liberal economic policy was capable of representing the interests of private enterprise. Despite their criticism of the administration

[43] El Tiempo, 9th August 1946, pp. 33-34.
[44] "Economistas", El Tiempo, 15th March 1946, pp. 29-30.
[45] Ibid.

of Manuel Ávila Camacho for being under the sway of Cardenist ideology, they recognise that the government – and de Iturbide himself mentions this in the interview referred to above – never put up the slightest resistance to their development of the educational project of the Asociación Mexicana de Cultura.

7. Some of the Leaders of the Project

The president of the Asociación Mexicana de Cultura, from its establishment and up until his death in 1967, was Raúl Baillères, a banker who in 1934 founded Crédito Minero, S.A. (later Banca Cremi), the first Mexican bank specialising in the financing of mining concerns. He later founded the financial institutions Crédito Hipotecario, S.A., and Crédito Afianzador, S.A.; and from 1941 to 1942 he was the president of the Association of Mexican Bankers. In 1941, Baillères was also the leader of a group of investors with controlling stakes in the brewery Compañía Cervecera Moctezuma based in Monterrey, and in the chain of department stores El Palacio de Hierro[46].

Baillères pursued many of these business interests in the nineteen-thirties as part of the BUDA financial group, made up of himself, Salvador Ugarte, Mario Domínguez and Ernesto J. Amezcua; the four were also founders of the Asociación Mexicana de Cultura and together they established and expanded several large business ventures[47].

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[46] Baillères, 1988, p. 6.

[47] In 1932, on the initiative of Salvador Ugarte, the financial institution Banco de Comercio was formed (later Bancomer and now BBVA). Raúl Baillèr esplayed a leading role in this project, and the bank's institutional organisation was entrusted to Aníbal de Iturbide. Collaborators on this project included Mario Domínguez, Ernesto Amezcua and Liberto Senderos. A short time later, they would go on to establish Crédito Hipotecario, S.A. and Crédito Afianzador, S.A. together. They would also play a part in the creation of Banco General de Capitalización, founded in 1934. In 1956, disagreements over the control of Banco de Comercio caused the departure of

Raúl Baillères, the project leader, was opposed to the government's statist strategy, which in his opinion had seized control of a large number of companies and had thereby limited the scope of action for private enterprise:

> He was intuitively convinced that the system could not work and that Mexico needed a free society with private enterprise as its engine of economic development[48].

Aníbal de Iturbide introduced Raúl Baillères to Luís Montes de Oca, and of this encounter he says:

> I was the one who brought them together. Luís was the ideas man, and Raúl the one who provided financial support[49].

De Iturbide goes on: "the two of them and a group of distinguished friends, now all departed, created the Asociación Mexicana de Cultura and the Instituto Tecnológico Autónomo de México (ITAM)."[50]

Baillères declared at the time:

> We are going to educate young men so that, in 30 or 40 years, they can carry out the transformation from a statist country to a liberal capitalist country[51].

Luís Montes de Oca was a certified public accountant. He played an important role in directing the country's finances during the period of economic reconstruction: President Plutarco Elías

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Raúl Baillères and several board members from the bank. Later on, de Iturbide (who had resigned from the bank in 1955) and Baillères were invited to work for Banco Comercial Mexicano (Comermex) as CEO and board member, respectively.

[48] Baillères, 1994, p. 36.

[49] Ibid.

[50] Ibid.

[51] Ibid.

Calles appointed him as Auditor General of the Nation in 1924, and he remained in the post until 1927, when he was named Minister of Public Finance (1927—1932). During the administration of Lázaro Cárdenas, between 1935 and 1940, he was Director of the Bank of Mexico, and he subsequently retired from politics to make a career for himself as a private banker. In 1941, he brought together a group of businessmen to form Banco Internacional. Montes de Oca was the founding partner of the Asociación Mexicana de Cultura who had the strongest links with Mexican intellectuals, and it was through him that the ITM was able to recruit Miguel Palacios Macedo, a lecturer at the National School of Economics, to teach History of Economic Thought and Economic Theory at the newly founded Institute[52]. In interview, de Iturbide stated:

> Within the Asociación Mexicana de Cultura, we had the fortune to have a man of exceptional intellectual capabilities: don Luís Montes de Oca, who had been the Minister of Finance and Director of the Bank of Mexico. At the time he was retired from politics. He was an extraordinarily cultured man, and one with good relations with other talented men. He was the vehicle that allowed us to contact and attract to the ITM people... who were very influential, such as Miguel Palacios Macedo, the most important person in the development of the School of Economics[53].

Carlos Novoa was a private banker who also held a series of top-level positions: President of the National Banking Commission, 1933; President of the Association of Mexican Bankers, 1945—1946; and Director of the Bank of Mexico from 1946 to 1952. Carlos Novoa was the son of Eduardo Novoa, who was Porfirio Díaz's Deputy Justice Minister. His career, like that of Montes de Oca, was in public and private finance. At the same time that he held a promi-

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[52] Negrete, 1988, p. 10.
[53] Ibid.

nent government position, he was providing support for a project that was at cross purposes with the prevailing economic policy[54].

Scholar Nora Hamilton maintains that the post-revolutionary government, as well as creating the conditions for the accumulation of capital, forged a new political class. Once the armed struggle was over, revolutionary generals continued to control several regions within the country. The government appeased and controlled these military men by providing them with financial dispensations and channelling their political ambitions into business activities. Hamilton asserts that a classic example of this process was Aarón Sáenz[55]. At 26 he was the head of General Álvaro Obregón's presidential guard, the Estado Mayor Presidencial, and he maintained a close friendship with the President; in 1924, Obregón appointed him Minister for Foreign Relations; from 1927 to 1930, he was governor of his home state, Nuevo León[56]; and he was Minister for Industry and Trade from 1930 to 1931. Aarón Sáenz then went from his role in the military and in the government to being a businessman. He became a sugar magnate, who made a fortune on the strength of the political connections he had acquired during the Revolution and then in the public offices he held. Sáenz had close links to conservative business groups in Monterrey, and he was also president of Banco Azucarero, a bank that specialised in investments in the sugar industry, which would later become Banco de Industria y Comercio[57]. He was one of the main founding partners of Banco Internacional, together with Montes de Oca:

> Sáenz's wealth apparently originated during his government career with the establishment of a construction firm (in association with President Calles) which benefited from government contracts. He and Calles,...were also associated in the construction of a major

[54] Camp, 1992, pp. 410-411.
[55] Hamilton, 1982, pp. 40-41.
[56] See also: Tapia Fabián, ÁaronSaénz. http://www.sre.gob.mx/acervo /can2_3.pdf.
[57] Hamilton, 1982, pp. 40-41.

> sugar refinery at El Mante, in the state of Tamaulipas. Sáenz, Calles and other government officials obtained the lands after a dam and irrigation system had been constructed at government expense, and a modern sugar refinery was built with the assistance of a substantial loan from the Banco de México[58].

Another important member of the Association was Aníbal de Iturbide, Director of Banco Nacional de México in 1945 and of Banco Comercial Mexicano in 1955. For two terms, he was president of the Association of Mexican Bankers. He was a key figure in the creation of the liberal school of thought, and was one of the most prominent bankers of the twentieth century in Mexico. He was professional, efficient and competent, and he did not just have a technical interest in banking; he was also knowledgeable about the monetary and banking theory of the time, and played an active role in building up the country's banking and credit institutions. He stood out as a leader and intellectual guide in the sector. He participated in economic debate, and tried to influence the government's 'developmentalist' economic policy by insisting on stability as a prerequisite for development[59]. He was particularly active in debates on credit and currency.

Aníbal de Iturbide was a man that expressed and made public his ideas and opinions in a range of different documents. Several of his works are anthologised in the book *Visión científica y retrospectiva del crédito en México*. In April of 1954, at the XX Bankers' Convention held in Acapulco, Guerrero, he gave a talk entitled "The Real Importance of Public Spending for the Economy"[60]. One work in

[58] Ibid., p, 41.
[59] See: Visión Crítica Retrospectiva del Crédito en México published in 1963, volume 11 of the SELA Collection (Selección de Estudios Latinoamericanos), which contains several works by Aníbal de Iturbide from the period between 1947 and 1960.
[60] "La importancia real del gasto público en la economía", talk given by Aníbal de Iturbide, General Manager of Banco de Comercio S.A. at the XX Bankers' Convention held in Acapulco, Guerrero, on 26th April 1954.

particular that summarises his thoughts on currency and credit was the conference "Monetary and Credit Policy", which he presented in his capacity as Director of the Bank of Mexico at the Instituto Tecnológico de México in April of 1959[61].

At this conference, he maintains that the country's fundamental problems are dependent on monetary stability, and he goes on to add:

> Thus the need to re-examine our monetary policy and practice is a task that must be carried out without delay. The lack of stability in the value of our peso is today the most urgent problem, and the one with the most wide-ranging consequences, for the wellbeing of our nation; for this reason, I firmly believe that all other aims of economic policy should immediately be subordinated to the fundamental objective of keeping our currency stable[62].

In his speech, de Iturbide also took the Mexican monetary and banking authorities to task over the role of the Bank of Mexico, as a central bank whose job it was to promote economic development in the country, and railed against the use of the public deficit as an instrument for development[63].

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[61] The conference was held on Wednesday 15th April 1959 in the auditorium of the Instituto Tecnológico de México, with Ernesto Fernández Hurtado, Deputy Director of the Bank of Mexico, Josué Sáenz and Víctor L. Urquidi as speakers. See: Iturbide, *Política*, 1959.

[62] Iturbide, 1959, p. 2.

[63] Aníbal de Iturbide held a wide range of positions throughout his career: General Manager of Banco de Comercio, S.A.; Chief Executive Officer of Banco Comercial Mexicano S.A. (1956); board member of the Asociación de Banqueros de México; board member of Tubos de Acero de México; board member of the Confederation of National Chambers of Commerce; board member of 24 separate banks affiliated to Banco de Comercio, S.A.; board member of La Comercial, Compañía de Seguros, S.A.; board member of La Almacenadora, S.A.; board member of Nacional de Drogas, S.A.; board member of Manantial Peñafiel; and alternate board member of Crédito Hipotecario S.A. He was also the Mexican delegate at the Interna-

8. The Austrian School in Mexico: Von Mises and Von Hayek

In the same year of 1946, a few months after the creation of the Asociación Mexicana de Cultura, this Association and the Bankers' Association extended an invitation to Mexico to two of the foremost representatives of the Austrian School: the teacher and his pupil, Ludwig von Mises and Friedrich von Hayek. They were both tireless fighters for economic and political freedom, who opposed fascism as much as they did socialism or F. D. Roosevelt's New Deal. Luis Montes de Oca once again assumed the role of their promoter and presenter at conferences.

9. No Economic Freedom Without Political Liberty

On the 22nd of July 1946, Professor Friedrich von Hayek of the London School of Economics arrived in Mexico City, at the invitation of the Association of Mexican Bankers and the Asociación Mexicana de Cultura. Hayek was an eminent disciple of Ludwig von Mises and author of the famous book published in 1944 *The Road to Serfdom*, in which he argued in favour of the free market and upheld the notion that a planned economy can never have enough information about individual preferences to allow the consumer to make an appropriate choice.

He gave three conferences at the Mexican Institute of Economics and the Confederation of Chambers of Commerce on the 24th, 25th and 29th of July[64]. The first two, on the 24th and 25th,

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tional Credit Conference in Rome; a member of the Commission for Review of the Credit Institutions Law; a member of the Economic and Fiscal Policy Council; and a member of the National Commission on the Economy organized by President Ávila Camacho during his final year of government. See: Romero, Aníbal de Iturbide, 2010, p. 157-162.

[64] Doctor Hayek was born in Vienna on the 8th of May 1899 and studied at the university in that city, where he obtained a doctorate in law in 1922 and another in political science in 1923. He worked in the Austrian civil service

centred on the topic of "Employment and Public Expenditure"; the subject of the conference of the 29th was "The Meaning of Competition". In the conference at the Chambers of Commerce, Professor Hayek also spoke on the subject of "The Political Consequences of Economic Planning". President of Banco Internacional Luís Montes de Oca – a self-declared enemy of economic planning and, like Professor Hayek[65], a supporter of neo-liberalism – presented the speaker to the audience. At the time, the president of the Bankers' Association was Carlos Novoa[66]. The magazine *El Tiempo* reported that the mere mention of Hayek's arrival in Mexico aroused the interest and stirred the passions of Mexican economic scholars. The most notable thing about the article, however, was the first appearance in the press of the term "neoliberal"; previously, visiting professors had been labelled as members of the Austrian School or the School of Vienna. In his final conference, Hayek expounded on one of his principal theses:

> …that political freedom is not possible without economic freedom, and that any planning or guidance of the economic activities of a country implies the guidance of the political activities of its citizens. He declared himself a supporter of a sys-

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from 1921 to 1926, and between 1927 and 1931 he was the Director of the Austrian Institute for Business Cycle Research. From 1929 to 1931 he was also a professor in political economics at the University of Vienna. In 1931 he was appointed professor of economic sciences and statistics at London University. He was a member of the British Academy and of the Royal Economic Society Council. Professor Hayek published the following works: Prices and Production, 1931; Monetary Theory and the Trade Cycle, 1933; Collectivist Economic Planning, 1935; Monetary Nationalism and International Stability, 1937; Profits, Interest, and Investment, 1939; The Pure Theory of Capital, 1941; The Road to Serfdom, 1944. See: El Universal, 17th July 1946.

[65] El Tiempo, 26th July 1946, pp. 45-46.

[66] El Universal, 17th July 1946.

> tem of private enterprise that would only allow a certain degree of planning in exceptional cases…[67]

Like Ludwig von Mises, von Hayek does not stop at an appreciation of the individual as merely an economically rational being, the maximising individual; instead, he sees the individual as a political being perhaps over and above a subject whose behaviour optimises the economy. This is an essential point that differentiates this school of thought from the old liberalism.

In his conferences, addressed to a public made up of bankers, he challenged the policy of public works in a period of high inflation as, in his opinion, this would accentuate the imbalance between investments and savings. He stressed that the regulating mechanism in the economy was competition, not the State.

Hayek's views were echoed in the Mexican business world. At a conference he gave on Industrial Planning at the National School of Economics before Hayek's arrival in the country, José R. Colín, President of the Mexican Chamber of Manufacturing Industry, said in reference to the Austrian scholar that

> …This writer's thesis has been found time and again in the theses put forward by different employers' organisations in our own country, where the Austrian economist's arguments have been repeated[68].

Colín's comment begs the question: Did Montes de Oca introduce Mexico's business leaders to Hayek's theories, or were they simply theories that were well received by the country's business community?

Hayek's presence in Mexico received a great deal of attention from the press. Nonetheless, it would appear that only the professor of economic theory at the UNAM's National School of Economics,

[67] El Nacional, 1st July 1946
[68] Revista de Economía Continental, vol. 1, no. 1, 15th August 1946.

Francisco Zamora, was prepared to debate his theories and to challenge the members of the Asociación Mexicana de Cultura. In a lengthy article published in the newspaper *El Universal*, Professor Zamora says:

> It is at once revealing and ironic that the first foreign academic invited to visit by the opulent association of bankers and industrialists, to whom is owed the youthful existence of the Instituto Mexicano de Economía and who almost plays the role of ideological
> godfather to the latter, is Professor Friedrich von Hayek. Revealing, because the distinguished economist is the most well-known and crowd-pulling star that economic liberalism has in these increasingly trying times; and ironic because among the prominent persons who invited him are many, perhaps the majority, who owe their relatively recently achieved fortunes and social standing to the anti-liberal intervention of the Mexican State in the economic activity of the nation, thanks to which monopolies have been created that have made them rich.
> Thus we find ourselves faced with an amusing paradox: Professor Hayek has come to Mexico to nurture the seed of the liberal economy, after having undertaken a similar mission with great success among the North American mesocracy, on the initiative and at the cost of a group of moneyed individuals whose wealth, in a great number of cases – it could be said in most cases – has its origins in government policy that is the polar opposite of the principles of liberalism. The patrons of this crusade against State intervention in the orientation and development of private enterprise without doubt have a wide range of backgrounds; but the fact that at least some of them have arrived at this point from the sectors of government finance, the sugar industry and the road haulage industry gives one justification to doubt the sincerity with which they are sponsoring this more or less scientific, liberal-economic propaganda exercise[69].

[69] Zamora, 1946.

Professor Zamora was referring specifically to the businessman Aarón Sáenz, who, as we have already mentioned, was a founding partner of the Asociación Mexicana de Cultura, a sugar-industry mogul and a person who had made his fortune under the protection of the 'developmentalist' State that he so harshly criticised.

10. Von Mises Returns

In August of 1946, Mises visited Mexico for a second time and joined Hayek. They travelled together to Lake Chapala in the state of Jalisco. In Guadalajara, Mises presented a conference and, once again, Montes de Oca was his translator. During his stay in Mexico City, Mises gave a series of talks that had been convened by Raúl Baillères, the president of the Asociación Mexicana de Cultura, and by the president of the Bankers' Association, Carlos Novoa. The subject of the first conference, held in the auditorium of the Instituto Mexicano de Economía, was "Interventionism; Ideological Foundations and Economic Consequences"[70]. The second conference, "The Crisis of Interventionism", was held at the same venue on the 14th of August[71].

Hours before giving the last of these talks, Von Mises met with members of the Mexico City Rotary Club at an elegant restaurant. He told the select group of financiers that he had been a member of the Vienna Rotary Club from 1929 to 1938, until Hitler disbanded Rotary Clubs in Austria, then in Germany the following year and subsequently in all the countries invaded by the Reich. On this occasion his speech was on price control[72]. The essential ideas that he put forward in both conferences referred to the obstacles or incen-

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[70] The Instituto Mexicano de Economía was located at Palma Norte 518, on the 6th floor. The conferences were held on the7th and 14th of August 1946, at 7 p.m. El Universal, 7th August 1946.
[71] El Universal, 8th August 1946.
[72] El Universal, 14th August 1946.

tives for the accumulation of capital in developing countries like Mexico:

> What these countries need, he said, is industrialisation, and for this it is necessary to have foreign capital. Exchange-rate controls (which do not exist in Mexico) and the policy of expropriation have prevented this capital from coming from abroad. Another method is State investment; but this, commented Ludwig Von Mises, is politically dubious... There is no other alternative, then, to the formation of capital internally. This could be achieved by creating the conditions for a quantitative and qualitative increase in production, as well as for an increase in the marginal product of labour.
> However the obstacles that hinder the accumulation of capital must be removed. Any action taken by the State to encourage [the accumulation of capital] is good; any action that deters it or makes it impossible is bad. Price controls and wage increases through the trade unions go against this goal...
> Price-control policy contains a structural contradiction: governments want on the one hand high prices for manufacturers, and on the other hand low prices for consumers. These opposing goals are simply impossible to reconcile. By removing barriers to foreign trade and food imports, lower prices would be achieved…[73]

Mises's recommendation for the process of accumulating capital in Mexico was free trade, which implied the mobility of capital and goods and the influx of foreign investment.

11. In the Company of Monterrey Businessmen

The Centro Bancario de Monterrey invited Von Mises, through the Asociación de Banqueros de México, to the city of Monterrey to give some of his talks on economics. This led to a conference that was held on Tuesday, the 20th of August 1946[74]. Mises's

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[73] Ibid.
[74] El Porvenir, Monterrey, 19th August 1946.

reflections once again centred on government interference and the development of private enterprise. He also spoke about the successes and failures of the Austrian School in the United States:

> The Austrian school of economic thought, explained Professor Von Mises, was studied and adapted by many of the economists in the United States who are advisors to the government. However, the start of the war threw the economic structure of that great nation into turmoil. In the opinion of Professor Von Mises, the country will soon recover from its current economic problems[75].

In Von Mises's opinion, economic recovery in the United States would have a favourable effect for Mexico, as inflation in Mexico was dependent on the neighbouring country to the north. As he said to a reporter from the newspaper *El Porvenir*:

> As soon as that great nation improves its economic situation, inflation in Mexico will stop.
> Mexico did not have the choice to go or not to go down the dangerous path of inflation. Price controls in the United States, which have now been regulated differently to how they were before, will soon make American industry surpass itself. This, I assure you, is colossal. It is not just the vision of a European scientist with regard to the potential of this great American continent[76].

Von Mises takes note of the interrelation that existed between the two economies. However, he does not consider Mexico's economic dependence on the United States as something harmful; rather, it is an essential part of Mexico's condition as a backward country.

The following day, the 21st of August, Von Mises continued with his talks with groups of business leaders from Monterrey. The central topics of this conference were: State interventionism and the

[75] El Porvenir, Monterrey, 20th August 1946.
[76] Ibid.

price-control system. Nazi Germany and Socialist Russia were the historical examples that Von Mises made constant reference to. In his opinion, State interventionism had direct effects on the political system. He says: “It is clear that interventionism on the part of the State is self-destructive, because it restricts parliamentarianism, limits the freedom of the press, overlaps with labour interests, and destroys private enterprise and political freedom of thought”[77].

He went on to talk about the price-control system as one of the most detrimental forms of State interventionism:

> The price-control system, said Von Mises, is one of the most flagrant forms of interventionism. The system results from the inflation created by governments. Governments should not be said to combat inflation, but rather its effects...
> Of course what the price-control system results in, once the government has failed in its intervention to dictate the economic index of a given product, is the farmer or the industrialist that produces the product whose price has been capped by the government simply abandoning his crop or his production, because the benefit created by the activity decreases. When supply goes down but demand remains the same, the value of the article increases outside the regulated market, creating one fictional price and one black-market price; this leads to inflation because the government is incapable of controlling the rise in the price of the article due to demand. The government eventually is forced to abandon its price interference and to accept the inflation, and must then try to combat inflation after the fact[78].

Mises also held meetings with several business concerns from the region: accompanied by Virgilio Garza Jr., president of Crédito Industrial; Ignacio Martínez Jr., manager of Banco de Nuevo León; Francisco Maldonado, manager of Compañía General de Aceptaciones; and Jesús Velasco, manager of Banco de Monterrey, he visited several local factories, gave a conference at Banco de

[77] El Porvenir, Monterrey, 21st August 1946.
[78] Ibid.

Crédito Industrial, and dined with a group of bankers at the Casino de Monterrey. As we can see, Mises and Hayek had a very busy schedule on the visit they paid to Mexico's business community.

12. Mont Pelerin Society in Mexico

On the 10th of April 1947, the Mont Pelerin Society was created by a group of mainly economists, historians and philosophers from the academic world, under the leadership of Friedrich August von Hayek and Albert Hunold[79]. Among other notables who formed the society were Ludwig von Mises, Milton Friedman and the philosopher Karl Popper[80]. At its inaugural meeting, a discussion was proposed of the State and the fate of classical liberalism. The group stated that:

> Its sole objective was to facilitate an exchange of ideas between like-minded scholars in the hope of strengthening the principles and practice of a free society and to study the workings, virtues, and defects of market-oriented economic systems[81].

The society's members described themselves as liberals, and they were opposed to theories that defended State interventionism such as those of John Maynard Keynes, which gained currency after the Second World War.

In the post-War period, those responsible for economic policy in various countries took inspiration from Keynesian theory to pursue the development of their respective economies. At the same time,

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[79] The society's name is taken from the Swiss resort where the group's first meeting was held. See: Harvey, "Breve", 2007, p. 26.

[80] For the society's articles of incorporation, see web site: http:www.montpelerin.org/aboutmps.html, and Harvey, "Breve", 2007, p. 27.

[81] http://www.montpelerin.org/montpelerin/mpsAbout.html.

neoliberals opposed the systems of centralised State planning. They argued that:

> Decisions made by States... were condemned to be politically biased on the basis of the interest groups that would be affected on each occasion (such as trade unions, environmental organisations or business lobbying interests). Any decisions made by States on investment and the accumulation of capital would always be erroneous, because the information available to the State could not compete with the information contained in the market[82].

The group held annual meetings in different cities around the world, and in September 1958, Mont Pelerin came to Mexico. The society's meeting was sponsored by the Instituto de Investigaciones Sociales y Económicas, A.C. The attending professors who were members of the society were: Bruno Leoni, Ernst Bieri, Bernard Pfister, Friedrich von Hayek, Albert Hunold, W. H. Hutt, John Van Sickle, Arthur A. Shenfield, Ludwig von Mises and Daniel Villey.

As well as conferences that were given by some of the members, a round table discussion was organised on the problems of the world economy. The two fundamental topics of the debate were inflation and official controls. There were also reflections on:

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[82] The members of the group described themselves as "liberals" (in the traditional European sense of the word) because of their fundamental commitment to the ideals of individual freedoms. The label "neoliberal" indicated that they were adherents of the free-market principles established by neoclassical economics, the movement that emerged in the second half of the 19th century (as a result of the work of Alfred Marshall, William Stanley Jevons and Leon Walras) and replaced the classical theories of Adam Smith, David Ricardo and Carlos Marx. Nonetheless, they stood by Adam Smith's conclusion that the invisible hand of the market was the best mechanism to mobilise even the basest of human instincts, such as gluttony, greed and the desire for wealth and power, for the common good. Harvey, "Breve", 2007, p. 27.

> …inflationist financial policy... and they warned that controls on prices, imports and exports would counteract the efforts of private enterprise and necessarily create negative effects on agricultural and industrial production and on the different business sectors; in the long term the economy would be brought down by a contraction in productive activity. We can only hope that these authoritative voices are heard in the spheres of government in Mexico, where the controlled economy has powerful sympathisers who stubbornly follow an inept policy of making the State the master of the land[83].

The Mont Pelerin intellectuals failed to achieve broad appeal in Mexico because at that time, the socalled "Mexican miracle" was at its peak and the Mexican State had adopted a model of development that ensured stability, with an economic policy in which State intervention played a fundamental role. Nonetheless, there were those among the country's élite who were determined to strengthen the liberal programme promoted by the organisation.

13. Epilogue

The economic programme of President Cárdenas, based on economic growth with the distribution of wealth, was seen in a negative light by some of Mexico's business leaders. Bankers and industrialists sought to create institutions that would counteract the movement, which was the cornerstone of Mexican 'developmentalism'. Within this context, it is easy to grasp the significance of the trips made to Mexico by the two most important members of the Austrian School – Von Mises and Von Hayek – whose aim was to provide ideological and theoretical support for the debate being waged by the Mexican élite against the nationalist Mexican State. They fulfilled their role of helping to articulate the dis-

[83] Excélsior, 2nd October 1958.

course of the group of Mexican businesses most closely linked to the international financial sector.

The élite took on the task of creating the conditions for the construction of an alternative project to Cardenism, and therefore to economic nationalism. The establishment of higher education institutions was the most significant means employed to help realise this ideal. An example is the Instituto Tecnológico de México; from the time it was founded, both the Institute's administrators and the members of the Asociación Mexicana de Cultura began submitting the necessary applications to the corresponding authorities to achieve full academic independence for the institution. On the 10th of April 1962, President Adolfo López Mateos signed a decree granting the institution its independence[84]. This gave the institute complete freedom to design study plans, programmes and methods of teaching, and it became the Instituto Tecnológico Autónomo de México (ITAM). The institute became an important source of young people with technical expertise as economists and a different way of thinking about economics to that which was prevalent in the so-called 'developmentalist' stage, who then went on to implement the political project conceived by their educators.

Things did not stop there. The group of business leaders would continue to create institutions throughout the second half of the twentieth century. On the 13th of September 1962, on the initiative of the businessman Bruno Bagliani, the Mexican Council of Businessmen (CMHN) was founded. The organisation ostensibly had the objective of creating a mechanism for arbitration between business, the State and civil society[85], although banker Aníbal de Iturbide suggests that the business group was established with the aim of creating a direct channel of communication with the top levels of political power and of representing the country's most important business leaders.

[84] The decree was published in the Official Federal Gazette on the 19th of January 1963, at a time when the Minister for Public Education was Jaime Torres Bodet. Miguel González Avelarand and Porfirio Muñoz Ledo participated in drafting the decree. See: Opción, April 1988, p. 44.
[85] Brito, 2002, p. 81.

Over time, and for the rest of the twentieth century, the demands of the group of business leaders who set about building institutions to promote liberalism and oppose economic nationalism remained: limitation of participation of the State in the economy, elimination of protectionism, and promotion of free trade and foreign investment.

To conclude, it is very important to emphasise that although the group with liberalist leanings was economically strong, not everyone in the Mexican business community was opposed to the ideology of economic nationalism. In fact, a group of business leaders emerged and became strong due to economic protection and the support of government policies. A detailed study has yet to be carried out as to what kinds of business interests, and from which sectors, were the ones who sought to create a project linked to liberalism during the twentieth century in Mexico.

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Chapter 7

The Change of Economic Institutions in Mexico: the NAFTA Era from 1983 to 2011

Juan Pablo Arroyo Ortiz

1. Changing institutions after 1982. The hypothesis

From 1936 to 1982 Mexico was ruled by a model of mixed economy, based on government economic intervention, which supported development. But in the early 1980's there was a change. A new model was introduced. In a long process of two decades (1982 to 2002). Another economic policy prevailed. It was based on the idea that the free market is the best way for allocating resources. Since 2002 to 2011 the new institutions of the neoliberal economic model were implemented.

Up to now it has been said that the fundamental reason for this change was the exhaustion of the import substitution model, previously applied. It is difficult to find the elements of such exhaustion (Moreno y Ross 2010), because it has never been explained in detail. The hypothesis of this paper is that, although we think that there was depletion, it was more influential the political defeat of those intellectuals and politicians who had supported the policy of economic intervention. They were overwhelmed by those who had long sought a model of an open economy and free market.

In the previous approach, those whom we call "developers”[1] were always concerned with the employment rate and a better income distribution. Their policy was based on the guidelines of multilateral organizations (IMF, IBRD, WB, IDB, USAID and ECLAC)[2], and on their financial support, with low interest and long-term rates. They managed to have a long period of growth. The other path, preferred by liberal economists, achieved the globalization in the movements of goods, capital and securities, and reduced to a minimum the state interference in the economy. Finally the second group prevailed and was supported, in some reforms, by the measures that international institutions like the IMF and the World Bank suggested or imposed to debtor countries.

These suggestions were the consequence of the changes in the international financial system. Since the early 1970s, among the nations with the largest amount of foreign reserves, a new ideological attitude started (Eichengreen 1996). The Group of the most powerful seven nations in the world (G7), those who had the biggest monetary reserves, redefined financial economic relations. At the same time, we had great technological changes in computing, nanotechnology, the exploitation of new sources of oil and its petrochemical derivatives, and in the influence of information technology in the organizational theories. All these changes occurred so fast and deeply that they altered the way of production and circulation of goods and capitals. This new conditions led the world to the globalization of production and of the financial market. Such tendencies pressed for a change in economic policy. They provided political support to politicians, academics and intellectuals, in order to build up the model of a new economy, government and society.

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[1] In Spanish, “desarrollistas”. This concept can be applied to all Latin-American countries.

[2] IMF, International Monetary Fund. IBRD, International Bank for Reconstruction and Development. WB, World Bank. IDB, Interamerican Development Bank. USAID, US Agency for International Development. ECLAC, Economic Commission for Latin America and the Carribean

The purpose was to replace the previous mindset of development, based on industrialization and public employers, with the free market, where private enterprise is fundamental and central government is reduced to a minimum. The instrument that caused the change was the financial system, which encouraged borrowing and created conditional bailouts and derivatives. Some banks were privatized and organized cartels for the granting of debts.

In the more advanced nations, the economic change gradually also led to institutional changes, thanks to the weakening of the government's role in the economy. Keynes' theory and its applications for development and welfare were defeated by the liberal groups, who were linked to the financial sector. But the countries where oil extraction was dominant, as revenue source, and industrial production was not supported, lagged behind. The change began with the strong political influence of the financial system. Interest rates changed and prices of goods in international trade went down.

That was how, after adjustments of the economy and debt restructuring, the goal emerged of opening economies as a condition for growth. After the basic settings, the new government program was the Free Trade Agreement of North America (NAFTA). In it the main lines are embodied for the transformation of economic policy. Thus the NAFTA era began.

2. Features of the change

The new economic model led to the implementation of new institutions, which were seen as essential for achieving the functionality of liberal ideas. The new institutions are dominated by the ideology of free market. Their basic idea is to have a small and economically weak government, because they give prominence to the enterprise, the entrepreneur and supposedly to the consumer. This new approach puts at risk the integration and security of society, by asserting individual freedom as the basis of society. It eliminates any notion of collective social representation.

The main changes relate to the very role of the state. Public administration undergoes a reorganization, and the allocation of public spending is transformed. Production and market organization change. There is a wide opening of the market; a growing deregulation in both domestic and foreign trade; the international corporate capital and the national private capital replace public investments; private enterprise plays as the main engine of economic growth.

The main argument for such a sharp turn was the inefficiency and low productivity of state capital. In this process, monetary policy, the financial system and the payment system are modified to support the implementation of the stock market as a means of financing the economy. The new open economy adapts itself to the globalization of financial investments and to the subordination of production to foreign markets. Production for the domestic market is depressed; its investments are limited by the inequality in income distribution.

3. Historical perspective

Theoretically the welfare state derived from the analysis of J.M. Keynes, who invoked state intervention when the economy was unable to ensure its proper functioning because of market failures. Then in the areas with a monopoly concentration, with no proper information among operators, or with great inequality among buyers and sellers in the market game, the state should intervene through rules and regulations.

As a policy the welfare state derived directly from the post-war period, when Europe and Japan, helped by the US, implemented a policy of welfare, of nationalism, and economic strength in order to start reconstruction.

The Latin American countries, which were subordinated to the production for the war, also participated in this dynamic recovery. The Bretton Woods agreement (1944) inspired the making of the multinational institutions. So it was that international financial regulatory institutions and the trading system were established: the IMF, the World Bank and the General Agreement on Tariffs and Trade

(GATT). From this agreement many things derived: the prices' control of state enterprises; support for basic industries such as energy and transports; support for the basic consumer goods.

The instruments that promoted economic growth in the era of state intervention, with relative stability and wealth distribution, were: a) pricing and economic regulation in certain areas of production; b) public intervention in some production and services, especially in the supply of strategic raw materials and energy, that led to better conditions of accumulation and investment; c) credit supported by public and private investments under the leadership of the central bank, in the expectation of growth; d) funding and price support of exports; e) proper management of the money supply and of the exchange rate to preserve price stability.

The State intervened in the strategic economic areas, which were necessary for development but in which private capital had not been able to succeed. The concept was framed of mixed economy, government and business. One important aspect was monetary expansion with a fixed exchange rate, and the provision of credit with relatively low rates. This helped also private accumulation of capital, since a series of enterprises, funded with public capitals, provided key services or basic row materials. The growth of production and the monetary control were always sufficient to prevent the unbridled increase in prices.

But meanwhile liberal ideas were moving around the world against the welfare state. In the Seventies these ideas won and managed to remove any public influence in the economic governance (Harvey 2005). They also caused the ideological shift in the Schools of Economics of the major universities. This occurred throughout the Western world in a span of just twelve years, between 1978 and 1990. In Mexico the beginning of this process is the appointment of Miguel de la Madrid as a candidate for the presidency in October 1981.

According to the ideologists of liberalism, the state intervention in economy leads to authoritarianism and disturbs the proper allocation of resources (see Frederick Hayek, 2008, Ludwig Von Mises 1978, David Harvey, 2012). Their objective is to defeat the state apparatus (which represents a large part of the economy, with more than 2000 companies owned by the state or with a strong state involvement). The idea is to close up the institutions that promote a mixed economy and provide public subsidies and support. The ultimate aim is to give power to the class which holds the largest concentration of social income (Romero Sotelo 2012a, 2012b).

4. The theoretical debate in the world

In the international context, we must consider that in the post-war period socialism advanced and became a decisive factor in politics. While a sort of protected development prevailed in the West, mainly in American Continent and in Europe, other nations, like Russia, Eastern Europe, China and other parts of Asia opted for the socialist scheme with state ownership, political prices and government decisions about production. The central planning authorities arranged the size and quality of production, and set the relative wages and prices. In both projects, welfare state and socialist regime, the state's role was crucial.

The difference was about the nature of property: individual and private in one case, collective in the other. In the first case there was a sort of joint venture between private property and unequal distribution. In it the state always assumed its existence as limited, but substantial. Anyway in both cases the existence of a strong state was essential. Neo-liberal ideology, by supporting the elimination of the state from economy, criticized both the mixed economy and the socialist state.

The Mexican development took place in the context of this bipolar world. Mexico was led by political and geographical reasons close to the economics and politics of the United States. While the U.S. built their expansion policy in the world, after the end of World War II, with the Marshall Plan and the United States Agency for International Development from 1948 to 1955, a liberal stream emerged which radically criticized government intervention, and saw it as the "road to serfdom" of state authoritarianism against individual freedom. In the long run, both alternatives based on the state finished in a deadlock. J.M. Keynes and his followers had built up their theoretical framework on public investment. This approach produced the welfare state, but eventually arrived to a shortage of public financing. This led to stagflation and the concentration of financial capital in private hands. On the other hand, in the USSR the bureaucratic central planning authority ultimately failed, because its rigid procedure generated lack of technological adaptation, very low productivity and a distribution of goods strongly unbalanced.

Frederick Hayek and Ludwig Von Mises started the ideological opposition to state intervention as early as in 1944. Their thought formed businessmen and academics in the neoclassical economics and neo-liberal values. Their ideas became a political and philosophical banner. The Mont Pelerin Society, inspired by these two thinkers, held annual meetings and organized centers of cultural development and research. Such a society organized activities for many years and in many countries, mainly in universities, research institutes and government agencies. Particularly important were two of them, the economics program at the University of Chicago, and the Autonomous Technological Institute of Mexico: ITAM (Mirowski and Plehwe 2009, Arroyo 2012).

In Mexico there was never a theoretical discussion among politicians and academics. There was simply a battle for positions of power in the government, which implemented the new policies.

5. The international context in which the change occurred

The struggle around the welfare state policy and the regulation of the economic cycle through public spending gradually passed from an ideological confrontation to an "economic war" for the control of strategic materials - such as grains, industrial minerals, oil- and for the private control of the international financial system. The internationalization in the production of various corporate enterprises, gave the pace to technological changes in the fields of communications, electronics and organization of the production process.

The last attempt to strengthen the role of IMF as an institution promoting a strong state was the approval of the amendment of 1969 which created the Special Drawing Rights (SDRs). It allowed governments to support the fixed exchange rate. The reaction of the financial sector in the United States was radical. In 1971, when the French government claimed to change its foreign reserves into gold, the U.S. suspended the purchase and sale of gold for international transactions. The gold-dollar crisis began and opened the path to change (Eichengreen 1996). By then the Middle East crisis was at its peak. Oil price rose to record levels thanks to an agreement between the majority of producers, organized in OPEC.

A contextual aspect which had a strong impact, especially in oil prices, was the Six Day War in 1967 in the Middle East. Israel took the Sinai Peninsula and a large area of the Middle East. Five years after that, in October 1973, the Yom Kippur War made this context more complicated. That is the origin of the oil embargo and the reason for the rise in oil prices. That also functions as a counterweight to the claims against inflation in the United States that moves toward the rest of the world.

Economic negotiations to redefine the rules of the financial system within the G7 (the countries which together controlled most of the world's international reserves) were influenced by pressures due to the war and the oil crisis (Eichengreen1996). Another front was opened by the diplomatic negotiations in 1973 that signed the peace of Vietnam in Paris, France. The alliances in the Middle East between Egypt, Israel and the United States were consolidated, while on the other hand it raised tensions between Iran and Iraq. This led to the stagflation crisis in the United States. It occurred from the late1973 until 1978, with prices increase and deficit in the balance of payments. In the same period, France and West Germany were reluctant to limit the welfare state and held a covenant with social organizations.

But high oil prices and globalization of the oil problem, together with the reduction in prices of raw materials and food shortages, led to the beginning of the discussion on financial market reforms. This negotiation, that lasted more than eight years, was in the context of the Middle East war and the price changes in international market. At the same time there was a strong progress in information technology, organization and internationalization of production in various products and regions. But also at this time the situation opened space for political confrontation between socialists, social democrats and conservative liberals in the G7 countries.

When those long negotiations finished, a consolidation of agreements took place in 1978 in Kingston, Jamaica. The members of the Assembly agreed on a proposal of the most developed countries. This agreement established financial support to countries which had problems in their finances and currency. It also established the mandatory application of certain rules in the framework of economic liberalism, such as: reduction of government intervention, floating exchange rate, control of inflation through monetary tightening measures, stabilization of the deficit, control of internal and external credit. The IMF became supervisor for the implementation of measures for the private financial system, in order to grant loans according to free market rates. The reform was driven by the agreement between the G7 countries. It was a triumph of the neoliberal trend. It opened room to the triumph of Conservatives in England and Republicans in the United States. This agreement was also an explicit acceptance of the IMF interference in the internal politics of the signatory countries.

6. Facing the change. Mexico goes against

During the period 1971-79 in Mexico the state intervention was strengthened. The government spoke of a "shared development" strategy. This occurred in spite of investment restrictions, capital flight, and pressures by entrepreneurs, who insisted to reduce the size of government intervention and to have lower taxes. Paradoxically the boom in the oil market and the strategic geographical location encouraged Mexican government to implement a development project which would be supported by a state-controlled sector and would limit any intervention of international financial capital. Having disposal of oil and capital loans at low interest rates, the government had sufficient guarantees of foreign loans. At that time Western commercial banks were lending to all developing countries without limit and without adequate warrant. Mexico was no exception. The government increased public debt and offered to warrant the debt of large Mexican companies.

The decline in commodity prices and the increase in the prices of technology and capital goods led to the crisis that President Luis Echeverría faced in 1976. The deficit in the balance of payments and the pressure of capital flight forced the devaluation of the currency for the first time since 1954. However exports declined temporarily. A loan was negotiated with IMF and the government accepted to use oil resources in support of public finances as security for the debt that contracted (Memo Mexico-IMF 1976). The signing of this understanding caused the flight of capitals of the main investors, in 1976, and the forestalling of goods that caused shortages of various commodities. Business groups were the promoters of this pressure. They influenced the appointment of the presidential candidate and negotiated with him. The successor of Luis Echeverría, José López Portillo, would agree to lead the economy by means of reforms, and accepted in fact the dependency on foreign resources.

Some recommendations by the IMF were ratified by López Portillo in January 1977. They included the balance of the budget and the proposal that public finances could have but a small deficit. There was also the first reference to a floating exchange rate in many years. However the most relevant statement was this: the earnings of oil exports could be used to support the public finances because of the deterioration in commodity prices and in the terms of trade in general. When this agreement was negotiated, the information about the disposal of oil resources was not published yet; this would have been after the first act of the new government of López Portillo in December 1976. Because of the exploitation and export of crude oil, the debt with the IMF was redeemed soon (Arroyo 2005).

Moreover, in those years, with the assurance of high oil prices, international banks lent to private companies and commercial banks; while the government signed as guarantor. During the 1983 crisis, corporate debt was recognized as public debt. In this package the bank debt, acquired because of the expropriation, was also included. There were two ways to make the private debt public. One was the nationalization of the FICORCA[3] and of the other banks. The other was to pay with public money the debts of the banks. This, together with the government's own debt, formed the total amount of public debt, which determined the government's financial difficulties in the next 10 years. The foreign debt grew up from 22,000 US million dollars to 86,000 millions.

If one reads the terms of the engagements that Mexico signed in the agreement with the IMF in 1976, he can visualize the first signs of what would later be the adjustment program (which was conditioned by the loans contracted during the crisis of 1982). The terms of this program were the same mentioned above: financing public expenditure through the revenues coming from natural resources (oil); beginning of trade liberalization; reducing government spending; deregulation, cancellation of subsidies and privatization of public enterprises. Such principles were foreign to the policy and rhetoric of the State-Party (PRI)[4], but now they were supported by the power itself.

After 1979 oil prices were falling. In 1981-82 there was an inflation in the US economy and an extraordinary rise in interest rates. The US Federal Reserve forced Mexico to apply the new interest rates from 1979 to 1985. Then they rose from 4.5% to 24%.

Thus Mexico was in trouble for both the increased liability and the reduced earnings in foreign exchange. In this context capital flight occurred, the peso was devaluated. Then the cancellation of payment obligation was announced. The group that was elected in July 1982, led by Miguel de la Madrid, in complete agreement with the reforms suggested, led to a clearer willingness to implement the

[3] Fideicomiso de cobertura contra el riesgo cambiario". There were public resources that the government used to buy the private debt signed in dollars, and to put it in Mexican pesos.

[4] "Partido Revolucionario Institucional".

recommendations of the IMF, that were already part of the standard body.

It's in December 1982 that the implementation of a market model and the requirements of the adjustment program began. That program was already applied in other countries, and consisted in structural reforms. In that critical situation Mexico, being in a virtual absence of foreign exchange, could not import some essential goods. Then the Secretary Jesus Silva Herzog obtained a letter of intent for a Credit Agreement Extended by 4500 million dollars for the period January 1983 to December 1985. In these negotiations, unlike those of 1976, the first letter of Intent between the government and the IMF was signed. It established the conditional loan of IMF to commercial banks of 5000 million dollars.

The conditions imposed by the IMF and accepted by the government were: trade liberalization and deregulation of domestic trade, reducing the size of government through the sale of public enterprises, reduction of the deficit to the point of zero, reform of financing system, with the transformation of commercial banks. Both the memorandum of 1976 and the agreement of 1983, between the Mexican government and the IMF, are the main antecedent of acceptance to join the GATT and then the negotiation on NAFTA.

Thus, the IMF set the conditions for recovery and gave the resources to overcome the crisis stemming from international banks, through loans where several banks were associated. The engagement was to apply the adjustment program. Throughout the decade, Mexico's negotiations (which later paved the way for other developing countries) had a clearly evolutionary character. Each step was done in the beginning with great difficulty. The debt negotiation and institutional transformation, which went together, followed these steps: August to December 1982, the beginning; January 1983 to September 1985, first phase; 1986 to 1987, second phase; 1988 to 1993, third phase; finally 1994 to 2002.

7. Neoliberal's political success is in 1982

The negotiation of 1982 was the result of several years of confrontation between two groups in power, the technocrats (orthodox) and the nationalists (heterodox). The political triumph of the first group came with the appointment of Miguel de la Madrid as a candidate for the presidency of the Republic. Until that time, it was the President who defined the person who would be his successor. He used to do this after consulting the most influential political groups, which were at the basis of the decision. Elections were the formalization and legalization of a decision taken by the dominant political and business groups, in which also labor unions were involved, together with peasant representatives, financial capital and powers from abroad.

These arrangements operated since the constitution, in 1929, of the National Revolutionary Party (PNR), afterwards called Institutional Revolutionary Party (PRI). This was the first time in 60 years of PRI's governments that the decision was taken only by one political group, which wanted the transformation of the country inspired by a radical ideological conception, the neoliberal orthodoxy. This was the time of the political triumph of the technocrats over the nationalists. Since then we may say that the neoliberal group is in power.

The consequence of this institutional change was, since 1982, the acceptance and implementation of adjustment and stability programs, with the provisions included in the letters of intent signed with the IMF. The other element of institutional change was the decision to nationalize the banks and the beginning of the transformation of the financial system, with the rapid development of the stock market. The agreement assumed the features of "political pacts", which involved the most important forces in the decisions of government: employers, unions and some civil organizations that accepted the plan of adjustment.

After this agreement, a stabilization plan was implemented and the change of institutions started. The IMF recommendations were applied between 1983 and 1988. Later, after 1990, these changes were the building blocks of the conditions agreed in the Washington Consensus. The form taken by the first program is the Immediate Economic Reconstruction Program (PIRE) in 1983, which aims to restructure the economy in the short term. President de la Madrid made the announcement since the beginning and put it into practice immediately.

After several visits for monitoring and surveillance by the IMF missions, with successive updating of the letters of intent, there was progress on several issues such as budget setting, the search for a reduced fiscal deficit, trade liberalization and the gradual construction of the stock market. However the acceptance of excessive financial obligations, payment of debt service without the possibility of postponing it, the inability to sustain an appropriate price level, but also the effects of the earthquake in 1985, all this left the adjustment program with scarce results. The highest levels of inflation ever seen, mismatch of public finances, but also political instability because of internal ruptures in the political party, put seriously in doubt the government's intention to achieve price stability and to make further progress in the structural reforms. These years of low increase in production, hyperinflation and declining purchasing power of the population, are known as the "lost decade".

Stagnation and instability led to seek a solution to the crisis, which involved several countries. A controversy arose with the financial creditors: the United States, the representatives of banks and multinational agencies. The Secretary Silva Herzog stated the need for resources to grow. It was impossible to pay debts without an increase in economic activity and investments. He called for a debt restructuring that would include extension of time, low interest rates and a reduction of the total amount. The Mexican officials promoted a meeting of creditors in Cartagena in Colombia, and organized a debtors' club.

The denial by the creditors about debt restructuring led to the resignation of the Secretary Silva Herzog, just a few weeks before the meeting of IMF and World Bank in 1986 in Seoul, Korea. The meeting was attended by the new Secretary of Finance, Gustavo Petriccioli, who would accept without restrictions the conditions dictated by the creditors to all debtors in what became known as the Baker Plan. Reductions in debt obligations were allowed at the condition of a more profound and explicit reform in the institutional structure of Mexico.

The application of the Baker Plan was not sufficient to solve the problem of growth while still paying the debt. Then the Brady Plan was proposed and implemented in 1989/1990, for a new renegotiation with creditors. The implementation of reforms would be extended, but would be accepted by the US political forces and the G7 nations, later joined by Russia. This made, in November 1989, the Washington Consensus start. In Mexico there was the experiment of this agreement. In this country already many aspects of this agreement had been advanced.

This change of figures in the presidential cabinet of Miguel de la Madrid, gave strength and dominance to the group of technocrats headed by Carlos Salinas de Gortari. The latter in 1988 would remain in power as president. In the debates on the appointment of the presidential candidate, there were political differences. The electoral process altered the tradition of legitimizing the presidential designation. The electoral result that gave the victory to Salinas will always remain in doubt. It was in fact questioned, and the differences in the outcome of the vote was never clear. That dubious election raised the need to implement an electoral institution independent of the government to legitimize the elections. This fact closed the period of the State-Party, but left in power the group that would implement more forcefully the economic and political structural reforms inspired by the neoliberal model.

Thus the Washington Consensus approach was first implemented and experimented in Mexico since 1983. Then it was the basis for the acceptance of a more binding and strong rule, that is the international treaties that would be signed later in 1994. This opened the treaty era, with the American Free Trade Agreement (NAFTA). Such a project had been prepared for years, but till then it had not found the conditions required for its full implementation. After the reforms introduced from 1983 to 1993, the NAFTA agreement allowed the final access to the GATT, the free movement of capital, the constitution of the stock market, privatization of public enterprises (including banks that would have been nationalized in 1982) and the autonomy of the central bank.

The institutional framework had changed. In 1994 there was a presidential candidate, Luis Donaldo Colosio, who could have put in doubt the above mentioned reforms. Because of this, he was assassinated through a derangement. Then Ernesto Zedillo went into power. He was a strong follower of liberal reforms, and strengthened all of them.

NAFTA became effective in January 1994. It had the year 2009 as the deadline for its full implementation. Since the beginning there were the conditions for a new economy based on open market and backed by the force of law and by international conventions. Mexico agreed, once and for all, on an economic program which has at its basis a deregulated economy, with limited government interference, a reduced deficit, floating exchange rate. This economic and social model was completely different from that which had been supported by the state-party, which followed the ideology of the Mexican Revolution. The NAFTA is more than a free trade agreement. It is the legal frame of the new relationships between Mexico, Canada and USA; that involves also governmental decisions of economic policy, and other binding engagements in various fields.

The international context is essential in order to understand the evolution of economic policy that Mexico underwent. The negotiations about the financial crisis, which changed the Bretton Woods agreement, occurred at the time of the privatization of the banking system and the reform in the financial system. The financial support did not come anymore from the most important countries through multilateral organizations. The financial powers, that now included also Germany and Japan, decided to establish private international financial markets, stocks and securities firms, the bonds of government debt. Agreements about consumer goods and capital goods, project investments and development of new technologies will be negotiated in a global market. All this would be established, in a network with perfect and secure lines of communication, from the financial centers of Wall Street in New York to the City of London and other stock exchange centers, like Paris, Frankfurt and Tokyo. Around these, other stock exchange centers are connected in real time. This is the basis of what is understood as globalization in the late twentieth and early twenty-first centuries. The global stock market is one of the main institutions built for the working of economy in the XXI century.

This financial structure calls for open economies in the trade of goods, but the most important thing is the flow of capitals. The open market is supported by the idea of full freedom for the individual. The basic principle is that there must be no obstacles to prevent consumer decisions. The government has to reduce its scope of action in society, apart from public safety, education and health care. In some cases room is left to public infrastructures.

This approach replaces the idea of protecting production with subsidies and other support, with the aim of growth. The new logic is based on productivity, competition and free trade, to the benefit of consumers. It is assumed that citizens as consumers are adults and are able to decide for themselves without the guidance of government.

8. Conclusion

Thirty years after the start of liberal reforms that changed the social system, we can find that they are not yet fully implemented, and have not yielded the expected results. In fact economic stagnation prevails, with low growth rates and increasing poverty. The middle class has not emerged, human conditions of the majority of population are not improved, dependence and subordination to the US economy is growing. Mexico remains the provider of cheap labor and raw materials with very low costs, and is increasingly linked to the US cycle of industrial production and consumption.

The radical orthodox groups maintain that the measures implemented have fundamental flaws; they have not been applied as they should; there have been populist concessions. Gradualists maintain that the present policy should keep following the same path; because we have to wait for processes to mature. But eventually there emerges, although with little force, the search for alternatives. It is based on the critique of structural failures, of the excessive concentration of wealth and the impoverishment of the population.

The main features of the institutional changes in Mexico, resulting from the structural adjustment program, implemented in different phases, and the subsequent acceptance of the rules of NAFTA, are the following.

1) ROLE OF THE GOVERNMENT AND FISCAL POLICY.

a) In this area we have a fundamental change in the state. It passes from a strong government intervention in the economy to an attitude that waives any interference. Now it confines itself to the political and social task of the modern state: health care, education, and poverty relief.

In the new framework, the government renounces to control certain products considered strategic, such as fertilizers, petroleum and chemical industry. The main purpose of this reform was to make the companies responsible for their activity and to reduce radically the government activity.

b) A most debated argument, since the beginning of the reforms, is why tax collection gives so low revenues. It has been attributed to the bad efficiency of the institutions in charge of taxation. But it has also been found that there is preferential treatment on tax exemptions and special regimes that have not changed after the reforms. When tax officials showed the intention to charge more taxes, tensions arose between the government and the business world. Since at present power is in favor of business, the government does not want to charge it by changing its fiscal policy. It looks for support by different income sources such as the exploitation and export of oil. The real problem is not the low efficiency of tax collection, it is rather the privileged treatment of investors and big business, who find many ways to avoid or evade taxes.

For the neoliberal approach, fiscal policy should not inhibit investments, and should strengthen indirect taxes on consumption.

c) Control of current expenditure. Decrease in the number of public employees. Transfer of public workers to the private sector, because public employees often enjoy better conditions than the private ones.

d) Restructuring Public Administration: reorganizing the system to make it more efficient. The reform has suppressed the Ministry of Public Property (Patrimonio Nacional). It also puts strong limits to the Economic Ministry: sections dealing with price control and control of public companies are redefined or suppressed; subsidies are eliminated.

The sale of assets of the public sector provides additional income which allows a deficit reduction.

e) Privatization of public enterprises. "The fundamental belief is that private enterprise is more efficient and more dynamic than the public company" (Alba Vega 1996). It involves the purpose to sell profitable public enterprises and to suppress the unprofitable; and to eliminate trusts in order to promote production.

2) PRODUCTION IN THE REAL ECONOMY: DEREGULATION

a) Elimination of price controls.

b) Withdrawal of the state from the market. Closure or privatization of state economic agencies.

c) Elimination of investment control and indiscriminate opening to foreign investment market.

d) Deregulation of the financial system, which means rising interest rates in order to increase savings. Financial support will be awarded to the most profitable projects.

3) INTEGRATION IN THE INTERNATIONAL MARKET ECONOMY

a) Support to a competitive exchange rate, to encourage exports.

b) Reduction of import duties in order to have cheaper goods. Local industries have to be more competitive or to close up.

c) Export incentives for agricultural products, previously produced only for the domestic market. Financial subsidies to the private sector.

d) Avoiding an unsettled trade balance, especially with the United States, the country's most important trading partner.

4) MONETARY AND FINANCIAL SECTOR.

a) *Ways of financing production*. In the new policy, resources for production are made available through the sale of securities in the market. In fact bank credit is expensive and difficult to be obtained. This new market condition, started in 1982, marginalizes banks and the government itself. It also stimulates the integration of the stock market and money market with the brokerage business.

b) *Giving autonomy to the Bank of Mexico*. Since 1993 the law grants the Central Bank only these tasks: achieving economic stability, checking the monetary supply and controlling the currency market against speculation. These functions promote a monetary policy to attract more investments.

The Central Bank also guarantees for the payments to the investors; it holds currency reserves equivalent to, or greater than the amounts invested in the market. It is also engaged to pay debt service and the principal, even in case the debt is restructured.

5) SOCIAL SECURITY

In the area of social services government spending provides for the population in poverty, basic education for poor children, health system, etc. These measures want decentralization, by delegating responsibilities to the municipal or regional level. It's remarkable how much public expenditure is devoted to these fields, although social security institutions of the former regime are still prevailing, such as the IMSS (Mexican Institute of Social Security) and the ISSSTE (Social Security Institute for State Workers). The most important reform is the one which has to do with the financial sector directly, that is the retirement pension system. In this area there is a new system that will be fulfilled in about 15 years.

In the present discussion there is a tendency to replace the two large institutions that are currently engaged with the unemployed (Chávez Presa et al. 2012).

6) THE LABOUR SPHERE

a) Implementation of a wage policy that limits the annual increases to the level of expected inflation. This allows wages to be a price benchmark that hinders price raising, and reflects a shrinking market for the gradual reduction of the consumption capacity.

b) Promoting the weakening of unions and their ability to exert political pressure, in order to reduce the presence of organized labor in politics.

c) The labor reform was passed in the final days of government, which ended in December 1, 2012. It contains greater facilities for entrepreneurs in their relationships with unions and workers. The new labor law allows more flexibility in hiring workers, in the settlement of contracts, in hiring outsourcing companies. This increases pressure on workers and the unions.

The declared purpose is to create more jobs. But in fact this reform does not create more jobs. For this purpose more investments should be promoted, and better wages should be allowed to enlarge the domestic market.

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